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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, ~~1944~~ 1945

No. ~~1125~~ 55

THE UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, APPELLANTS

vs.

NEW YORK TELEPHONE COMPANY

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK

FILED APRIL 7, 1945

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1125

THE UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, APPELLANTS

vs.

NEW YORK TELEPHONE COMPANY

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK

INDEX

A In District Court of the United States for the Southern District of New York

Civil Acttion File No. 24-211

NEW YORK TELEPHONE COMPANY, PLAINTIFF

v.

UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, DEFENDANTS

Summons

To the above named Defendants:

You are hereby summoned and required to serve upon Henry J. Friendly, one of the plaintiff's attorneys, whose address is 31 Nassau Street, New York, N. Y., an answer to the complaint which is herewith served upon you, within sixty days after service of this summons upon you, exclusive of the day of service. If you fail to do so, judgment by default will be taken against you for the relief demanded in the complaint.

(Signd.) GEORGE J. H. FOLLMER,
Clerk of Court.

Date: February 11th, 1944.

NOTE.—This summons is issued pursuant to Rule 4 of the Federal Rules of Civil Procedure.

B SUMMONS IN CIVIL ACTION

Returnable not later than sixty days after service.

Ralph W. Brown, 140 West Street, New York, N. Y.; Frank A. Fritz, 140 West Street, New York, N. Y.; Henry J. Friendly, 31 Nassau Street, New York, N. Y., Attorneys for plaintiff.

[File endorsement omitted.]

1 In United States District Court, Southern District of New York

NEW YORK TELEPHONE COMPANY, PLAINTIFF

v.

UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, DEFENDANTS

Complaint

Filed Feb. 11, 1944

To the Honorable the Judges of Said District Court:

Plaintiff, New York Telephone Company, brings this action pursuant to the provisions of the Communications Act of 1934,

approved June 19, 1934 (48 Stat. 1064, 1093; Code of Laws of the United States, Tit. 47, Sec. 402 (a)) and of the Urgent Deficiencies Appropriations Act, approved October 22, 1913 (38 Stat. 219, 220; Code of Laws of the United States, Tit. 28, Sec. 41 (28), 43–48 inclusive), permanently to enjoin, set aside, annul and suspend an order of the Federal Communications Commission, dated December 14, 1943, in the proceeding which is said Commission's Docket No. 6329, to which plaintiff was a party, and for its cause of action alleges upon information and belief as follows:

The Plaintiff

1. Plaintiff is a corporation duly organized and existing under the laws of the State of New York. Plaintiff has its principal office in the City of New York, State of New York, and in the Southern District thereof. Plaintiff maintains, and at all times referred to in this complaint has maintained, its principal books of account in the City of New York, State of New York, and in the Southern District thereof.

2 2. Plaintiff has been engaged since its incorporation in 1896, and is now engaged, in the business of furnishing telephone service to the public in the States of New York and Connecticut. In that business it furnishes local or exchange telephone service in towns, cities, and other localities in said states. It also furnishes intrastate and interstate toll or long distance service between points in said states and interstate and foreign toll service through physical connection with the lines of other telephone companies between points in said states and points outside thereof.

The Defendants

3. The United States of America is made a party defendant in this suit pursuant to said Acts of Congress hereinbefore named.

4. The Federal Communications Commission (sometimes hereinafter referred to as "the Commission") is an administrative agency created by the Communications Act of 1934 and is charged with the execution and enforcement of said Act.

The Nature of the Commission's Order

5. A copy of the Commission's order dated December 14, 1943 (sometimes hereinafter referred to as "the Order"), together with the Commission's Report which was made a part thereof, is annexed hereto marked "Exhibit A" and made a part hereof.

6. By the Order the Commission directed the plaintiff to reduce its surplus, as recorded on its books, by $4,166,510.57, this being an amount equal to the excess of the payments by the plaintiff to American Telephone and Telegraph Company (hereinafter referred to as "the American Company") for certain telephone plant purchased in the years 1925, 1926, 1927, and 1928, over the amount found by the Commission to represent the net book cost of such plant on the books of the American Company at the time of said purchases; to restate its investment in certain plant
3 so acquired at an amount less by $481,439.60 than the actual cost of such plant to the plaintiff; to restate its investment in certain other plant so acquired at an amount greater by $194,886.97 than the actual cost of such plant to the plaintiff; to balance the changes in its accounts required by the foregoing action by adding to its already adequate depreciation reserve the amount of $3,879,957.94; and to make various other entries in its accounts as set forth in the Order.

The Transactions Here in Question

A. The Purchases of Toll Plant

7. Prior to 1925 the American Company had furnished intrastate toll or long distance service between certain points within the State of New York. In 1925 it was agreed between the American Company and the plaintiff that the business of furnishing said intrastate toll or long distance service should be transferred to the plaintiff, which would perform the services theretofore performed by the American Company. The business so transferred was profitable in character, and the transfer of such business was reasonable and proper both as to the plaintiff and as to its subscribers.

8. In order to conduct the intrastate toll or long distance business so transferred, plaintiff purchased from the American Company certain outside toll plant (primarily poles, crossarms, guys and anchors, aerial wire and cable, underground cable, loading coils, conduit, and right-of-way) which had theretofore been owned by the American Company and used by it in the conduct of the business so transferred to the plaintiff. This property was acquired by the plaintiff in two transfers, as of November 1, 1925, and September 1, 1926, respectively.

9. As of December 31, 1928, the plaintiff purchased from the American Company a small amount of additional toll plant. This toll plant was required in order to handle certain interstate toll business which had been transferred by the American Company to the plaintiff.

4 10. The plaintiff paid the American Company for the property described in paragraphs 8 and 9 of this complaint the following purchase price:

1925 sale	$5,831,884.78
1926 sale	97,310.39
1928 sale	44,246.30
Total	5,973,441.47

This purchase price was agreed upon as being an amount equal to the structural value of the property, that is to say, the estimated cost of replacement or reproduction of the property less deterioration to the then existing conditions through wear and tear, obsolescence and inadequacy. The structural value of the property was determined by means of a field inspection and a detailed appraisal made in accordance with recognized engineering principles and procedures by experienced and well qualified inspectors and engineers. The purchase price paid by the plaintiff to the American Company for the property purchased was fair, reasonable and not in excess of the value of said property.

B. THE PURCHASE OF THE TELEPHONE "INSTRUMENTS"

11. Prior to December 31, 1927, the American Company, as holder of the fundamental Bell patents, owned three small but essential parts of the telephone equipment placed upon the premises of subscribers by the plaintiff and other companies which were licensed to use this equipment. These parts, to wit, the transmitter, the receiver, and an induction coil, were commonly known and are hereinafter referred to as "the instruments."

12. On December 31, 1927, the American Company sold to the plaintiff the instruments then in the service or in the supplies of the plaintiff. The plaintiff paid the American Company for the instruments so purchased $6,661,238.91. The purchase price was based upon the average price charged the American Company by Western Electric Company, the manufacturer of the instru-
5 ments, during the first nine months of 1927, less an allowance of 20% to reflect the then condition of the instruments. The said purchase price was approved by qualified engineers of the plaintiff, after investigation, as a fair and reasonable price. The said purchase price paid by the plaintiff to the American Company for the instruments was fair, reasonable, and not in excess of the value of said instruments. Similar sales of instruments were made at the same time and at the same price to all of the licensee companies of the American Company, including companies which were not controlled by the American Company.

The Relationship Between the Plaintiff and the American Company

13. The plaintiff is, and at all times referred to in this complaint has been, a separate and distinct corporate entity managed in its own interest by its own officers and directors. Although, at the time of the transactions referred to in paragraphs 7 to 12 inclusive of this complaint, the American Company owned all of the outstanding common stock of the plaintiff, throughout such time the plaintiff had outstanding in the hands of the public 250,000 shares of its 6½% $100 Cumulative Preferred Stock and in excess of $132,000,000 of Mortgage Bonds issued under three indentures between the plaintiff and various mortgage trustees, none of which shares of Preferred Stock or Mortgage Bonds were owned, directly or indirectly, by the American Company; and throughout such time all of the plaintiff's officers and at least two-thirds of plaintiff's directors were not directors, officers or employees of the American Company, and the plaintiff had its own employees, property and business, separate and apart from the employees, property and business of the American Company. At all times referred to in this complaint the plaintiff and the American Company have maintained separate and distinct records and accounts and have been required so to do by the regulatory authorities to which the plaintiff and the American Company were subject.

6

The Law Controlling Plaintiff's Accounting at the Time of the Purchases of the Toll Plant and Instruments From the American Company

14. At the time of the transactions referred to in paragraphs 7 to 12 inclusive of this complaint, the plaintiff was a telephone company "engaged in sending messages from one State, Territory or District of the United States to any other State, Territory, or District of the United States," within the meaning of Section 1 of the Interstate Commerce Act as amended by Section 7 of the Act approved June 18, 1910, 36 Stat. 539, 544; was subject to Section 20 of the Interstate Commerce Act, 24 Stat. 379, 386, as amended by the Act of June 29, 1906, 34 Stat. 584, 593, 594; and was prohibited by the said Section 20 from keeping any other accounts, records, or memoranda than those prescribed by the Interstate Commerce Commission.

15. The Interstate Commerce Commission, pursuant to the authority vested in it by said Section 20 of the Interstate Commerce Act as amended, entered an order, dated December 10, 1912, prescribing for certain telephone companies, including plaintiff,

a uniform system of accounts entitled "Uniform System of Accounts for Telephone Companies, First Issue" effective January 1, 1913. Said system was amended in minor respects by subsequent orders, dated December 22, 1914, July 24, 1923, January 8, 1925, and December 19, 1927. Said system was interpreted by an order of the Interstate Commerce Commission dated June 26, 1916, approving Accounting Bulletin No. 11.

16. Instruction 10 of the said "Uniform System of Accounts for Telephone Companies, First Issue" provided:

"10. Costs to be actual money costs.—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. When the consideration actually given for anything with respect to which a charge is made to any
7 fixed capital or other property account is anything other than money, the actual consideration should be described in the entry with sufficient fullness and particularity to identify it, and the amount charged should be the actual money value of such consideration at the time of the transaction."

17. Instruction 13 of said "Uniform System of Accounts for Telephone Companies, First Issue" provided:

"13. Plant and equipment and other property purchased.—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constitutent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, 'Other Intangible Capital,' and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts.

"Companies should be prepared to furnish the Commission, upon demand, a full report of the contract of acquisition, the consideration given therefor, the determination of the actual money value of such consideration if other than money, the appraisal, and the amounts charged to the respective accounts for
8 each plant or other such fixed capital purchased. The pur-

chaser is required to procure in connection with the acquisition of any such plant or other fixed capital all existing records, memoranda, and accounts in the possession or control of the grantor relating to the construction and improvement of such plant, and to preserve such records, memoranda, and accounts until authorized by law to destroy or otherwise dispose of them."

18. Said Accounting Bulletin No. 11 adopted by the order of the Interstate Commerce Commission, dated June 26, 1916, provided in Case No. 30 thereof:

"Query.—What items should be classified as 'going or completed plant' under section 13, page 33, 'Plant and equipment and other property purchased' of the Uniform System of Accounts for Class A and B companies?

"Answer.—The term 'going or completed plant' is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—

(1) A telephone company as a whole,
(2) An entire central office,
(3) A system of lines and stations within a given area, or
(4) A complete section of toll plant.

"The purchase by one company from another of several poles and appurtenances, a switchboard, or other minor portions of plant shall be treated in the same manner as the purchase of materials and supplies; i. e., the purchasing company shall charge the fixed capital accounts at cost, as provided in section 10, page 33, of the Uniform System of Accounts for Class A and B companies."

9 The Accounting Performed by Plaintiff With Respect to the Purchases of Toll Plant and Instruments from the American Company

A. The Toll Plant

19. The acquisition of the toll plant set forth in paragraphs 7 to 10 inclusive of this complaint constituted the acquisition of "a complete section of toll plant" within the meaning of Case No. 30 in Accounting Bulletin No. 11 of the Interstate Commerce Commission as set forth in paragraph 18 of this complaint. Accordingly, the accounting for these acquisitions was governed by Instruction 13 of the Uniform System of Accounts for Telephone Companies then in effect as set forth in paragraph 17 of this complaint. Since the purchase price paid by the plaintiff for each type of plant, equipment and other property acquired was the structural value determined by appraisal, as set forth in paragraph 10 of this complaint, the actual money cost of the property purchased, to

wit, $5,973,441.47, was distributed among the various plant accounts in the precise amount of the appraised structural value of the various types of property purchased.

B. THE INSTRUMENTS

20. The acquisition of the instruments set forth in paragraphs 11 and 12 of this complaint did not comprise the acquisition of a "going or completed plant" within the meaning of Case No. 30 of Accounting Bulletin No. 11 of the Interstate Commerce Commission, as set forth in paragraph 18 of this complaint. Accordingly, the accounting for these acquisitions was governed by Instruction 10 of the Uniform System of Accounts for Telephone Companies then in effect, as set forth in paragraph 16 of this complaint. The instruments were recorded in the plant accounts at the amount paid by the plaintiff to the American Company for the instruments, to wit, $6,661,238.91, this price having been determined as set forth in paragraph 12 of this complaint.

10 THE COMMUNICATIONS ACT OF 1934, THE COMMISSION'S UNIFORM SYSTEM OF ACCOUNTS, AND THE JUDICIAL PROCEEDINGS RELATING TO THE COMMISSION'S SYSTEM OF ACCOUNTS

21. The Interstate Commerce Commission's "Uniform System of Accounts for Telephone Companies, First Issue," interpreted and amended as above set forth, continued in effect until January 1, 1933. By order dated November 12, 1932, the Interstate Commerce Commission adopted a uniform system of accounts entitled "Uniform System of Accounts for Telephone Companies, First Revised Issue," effective, as to the plaintiff, as of January 1, 1933. Said Uniform System of Accounts, First Revised Issue, continued in effect until January 1, 1937, the effective date of the Uniform System of Accounts for Telephone Companies prescribed by the Federal Communications Commission. Said First Revised Issue of the Interstate Commerce Commission's Uniform System of Accounts did not require any change in the accounting which had been performed by plaintiff with respect to the transactions referred to in this complaint.

22. The Communications Act of 1934, 48 Stat. 1064, Code of Laws of the U. S., Tit. 47, Secs. 151 ff., was approved June 19, 1934, and became effective upon the organization of the Commission on July 11, 1934. Plaintiff is, and at all times since the effective date of the Communications Act of 1934 has been, a person engaged within the United States in interstate and foreign communication by wire or radio, within the meaning of Sec. 2 of said Act (Code of Laws of the U. S., Tit. 47, Sec. 152).

23. Sec. 220 of the said Act provides, in subdivisions (a) and (g) thereof, as follows:

"(a) The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records,
11 and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys.

* * * * * *

"(g) After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect."

24. On June 19, 1935, the Commission issued an order designated Telephone Division Order No. 7-C prescribing for the use of certain telephone companies subject to the Communications Act of 1934, including plaintiff, a system of accounts entitled "Uniform System of Accounts for Telephone Companies, Issue of June 19, 1935, effective January 1, 1936." The said Uniform System of Accounts differed from both of the Uniform Systems of Accounts theretofore prescribed for telephone companies by the Interstate Commerce Commission, among other respects, in requiring that in the case of certain acquisitions of property previously in telephone service, entries should be made showing the "original cost" to the first utility dedicating said property to the public use, and that any excess of the purchase price of said property over said "original cost" less the amounts of reserve requirements for depreciation and amortization of the property acquired should be charged to Account 100.4, "Telephone Plant Acquisition Adjustment." The instructions pertaining to the said Account 100.4 provided, among other things, that:

"The amounts recorded in this account with respect to
12 each property acquisition shall be disposed of, written off or provision shall be made for the amortization thereof in such manner as this Commission may direct."

25. Upon the promulgation of the Commission's said proposed Uniform System of Accounts, plaintiff and a number of other telephone companies filed in this Court a complaint against the defendants herein, in a proceeding entitled "American Telephone and Telegraph Company, et al., plaintiffs, against United States

of America and Federal Communications Commission, defendants, In Equity No. 81–366," to enjoin, set aside, annul and suspend the said proposed Uniform System of Accounts. The said complaint and the record in the said suit in this Court and in the Supreme Court of the United States are incorporated herein by reference as fully as if herein set forth at length.

The primary ground of said complaint was that the proposed Uniform System of Accounts would require the plaintiffs to write off from their investment accounts amounts which had been paid by them to other utility companies for telephone plant, to the extent that amounts so paid exceeded the original cost of said plant to the telephone company which had first dedicated it to the public use less the depreciation reserve requirement at the time of purchase. In particular, the plaintiffs set forth, in their complaint and in the affidavits submitted in support of their application for a preliminary injunction, that large amounts of property, acquired partly from affiliated and partly from independent companies, had been recorded on the books of the plaintiffs at its actual cost to them; that the provisions of the proposed Uniform System of Accounts (referred to in paragraph 24 of this complaint) required that plaintiffs restate their then existing property investment accounts by eliminating therefrom their recorded cost or investment in property so previously acquired by them from another public utility and by substituting for such recorded cost or investment the amount which said property cost some former owner at the date of first dedication to public use;
13 and that where plaintiffs had theretofore purchased property at a price higher than its cost to the predecessor utility which first dedicated it to the public use, the said provisions of the proposed Uniform System of Accounts required the plaintiffs to write off a portion of their actual investment even where the price paid was the actual value of the property and where there had since been no change in value, thus requiring the plaintiffs to record a loss on their books when in fact they had suffered no loss.

26. The defendants herein denied in the said suit that the proposed Uniform System of Accounts had the meaning or effect of requiring a write-off of the excess of the purchase price to another utility over the "original cost" of the property and asserted that the effect of the said proposed Uniform System of Accounts was merely to require a reclassification of existing balances among various accounts for the better information of the regulatory authorities. In its answer to the said complaint, filed in this Court on December 13, 1935, the Commission denied "that the definition of original cost taken in connection with other provisions of the Uniform System of Accounts will require the plaintiffs

so to restate, as of January 1, 1936, their property investment accounts by eliminating therefrom the recorded cost or investment of the plaintiffs in property theretofore acquired by them from another public utility." In its answer to the said complaint, filed in this Court on December 23, 1935, the United States of America denied "that the definition of 'original cost' as contained in and read with the context of the Uniform System of Accounts will require plaintiffs in substance or in effect to so restate as of January 1, 1936, their property investment accounts by eliminating therefrom their recorded cost or investment in property theretofore acquired by them from another public utility."

27. The said suit was submitted to this Court for final determination upon the pleadings, affidavits and briefs submitted upon the application for an interlocutory injunction. This Court entered a decree restraining the enforcement of the proposed Uni-
14 form System of Accounts as to two items, and otherwise denied the injunction prayed for by the plaintiffs, but did so in express reliance upon the above mentioned representations of the defendants as to the construction and effect of the said System of Accounts, as is shown in this Court's findings of fact Nos. III–XIII inclusive. Said findings are set forth in Exhibit B which is annexed hereto and made a part hereof.

28. The defendants in the said suit took no appeal from the judgment of this Court. The plaintiffs in said suit, including the plaintiff herein, appealed to the Supreme Court of the United States. The plaintiffs contended in their appeal that the proposed Uniform System of Accounts was illegal and void primarily in that it would enable the Commission to require the accounting company to write off to surplus amounts paid to another public utility for property in excess of cost to the company first dedicating the property to the public use. The defendants herein defended the appeal on the ground that the purpose of the provisions in question was not to permit the Commission to compel such a write-off but to reveal information necessary to the regulatory functions of the Commission. The Supreme Court affirmed the judgment of this Court in an opinion reported in 299 U. S. 232. The said opinion expressly took note of the frequency of transfers between member companies of the Bell System and upheld the proposed Uniform System of Accounts as a means for obtaining full information with respect to such transfers and as not affecting the rights of the accounting company to retain in its investment accounts an excess of purchase price over original cost which was a true increment of value. Moreover, in order "to avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed" (299 U. S.

at 241), the Supreme Court required the United States and the
Commission to file with it a memorandum embodying the inter-
pretation of the proposed Uniform System of Accounts on which
the defendants had relied in defending the said suit, and the
15 Court accepted "this declaration as an administrative con-
struction binding upon the Commission in its future deal-
ings with the companies" (299 U. S. at 241). A copy of the memo-
randum so filed is annexed hereto marked Exhibit C and made a
part hereof.

29. After the determination of the said suit by the Supreme Court of the United States, the Commission promulgated its Uniform System of Accounts for Class A and Class B Telephone Companies, effective January 1, 1937. The instructions in said System of Accounts with respect to the accounting for telephone plant acquired did not vary substantially from the corresponding instructions in the proposed Uniform System of Accounts, which had been prescribed to be effective January 1, 1936, but which had not taken effect pending the final determination of the suit referred to in paragraphs 25 to 28 inclusive of this complaint, except that Instruction 31.2–21 provided that the "original cost" method of accounting was required only "when property comprising a substantially complete telephone system, exchange, or toll line is acquired from predecessors," and that the accounting for other property acquired from predecessors "shall be on the basis of the amount of money actually paid (or the current money value of any consideration other than money exchanged for such property."

Plaintiff's Depreciation and Retirement Accounting and Rates

30. Pursuant to the provisions of the Uniform System of Ac-
counts for Telephone Companies prescribed by the Interstate Com-
merce Commission and the Commission, plaintiff has followed the
group method of depreciation accounting. Under this system of
depreciation accounting, the plaintiff has charged depreciation
expense for each class of depreciable plant, including the plant
purchased from the American Company as set forth in paragraphs
7 to 12 inclusive of this complaint. The depreciation expense so
charged has been the product of applying to the book bal-
16 ances for each class of depreciable plant, rates estimated
by plaintiff's management to be adequate to distribute
evenly the loss in service value of the property in such class,
under the straight-line method of depreciation. In determining
such rates consideration has been given to the service lives and
salvage developed by studies of the plaintiff's history and ex-

perience; to the fact that at the time of acquisition of certain of plaintiff's property, including the property purchased from the American Company as set forth in paragraphs 7 to 12 inclusive of this complaint, a portion of the service life of said property had expired; to such engineering and other information as was available with respect to past and probable future conditions; and to all other relevant facts. The charges so made by the plaintiff for depreciation expense have been reasonable and adequate.

31. Depreciation expense charged by plaintiff to operating expenses, as set forth in paragraph 30 of this complaint, has been concurrently credited to a depreciation reserve. This depreciation reserve is, and at all times from 1925 to date has been, a single reserve for all of plaintiff's depreciable property. At all times from 1925 to date, the plaintiff's depreciation reserve has been adequate in the light of the nature of plaintiff's depreciable property and the estimated service lives and salvage of such property, including the property purchased from the American Company as set forth in paragraphs 7 to 12 of this complaint.

32. The rates charged by plaintiff for its intrastate service in the State of New York, revenues from which comprise over 90% of plaintiff's total operating revenues, at all times from November 1, 1925, to date, have been rates which have been fixed and determined by the Public Service Commission of the State of New York, except that until July 1, 1926, plaintiff made certain charges in excess of such rates pursuant to an order of this Court finding that the rates so fixed and determined by the said Public Service Commission were confiscatory.

17 33. In determining the rates to be charged by the plaintiff for its intrastate service in the State of New York, the said Public Service Commission of the State of New York, in rate proceedings before it, has made its own estimates of plaintiff's annual requirements for depreciation, and has fixed plaintiff's rates upon the basis of said estimates and not upon the basis of plaintiff's actual depreciation charges. In the suit in equity in this Court entitled "New York Telephone Company, Plaintiff, against William A. Prendergast et al., Defendants, In Equity No. 29-126," this Court in its opinion dated November 7, 1929, approved a finding estimating plaintiff's future depreciation charge at a composite rate of 5.1% per annum upon all of its depreciable property, including the property purchased from the American Company as set forth in paragraphs 7 to 12 inclusive of this complaint. The depreciation rate so approved by this Court was adopted by the Public Service Commission of the State of New York in fixing rates to be charged by the plaintiff for intrastate telephone service within the State of New York in its decision in its Case No. 6177 dated May 1, 1930. Plaintiff's composite depreciation rate was reduced

to 4.5% per annum in 1933, and to 4.18% per annum on January 1, 1936. In its decision dated June 29, 1936, in its Case No. 8230, fixing reduced rates to be charged by the plaintiff for intrastate telephone service within the State of New York, the said Public Service Commission determined the said composite rate of 4.18% per annum to be higher than required and that plaintiff should file new and revised rates. Plaintiff thereupon made a reduction of approximately 10% in its depreciation rates. The facts as to the acquisitions of property by the plaintiff from the American Company set forth in this complaint were presented to this Court in the above mentioned suit in equity (No. 29-126), to which the said Public Service Commission was a party defendant, and the said Public Service Commission was then and at all times subsequent thereto has been fully apprised in regard to such acquisitions. No orders have been made by the Federal Communications
18 Commission fixing depreciation rates for the plaintiff pursuant to Sec. 220 of the Communications Act of 1934.

34. From time to time, after the acquisition of the toll plant and the instruments referred to in paragraphs 7 to 12 inclusive of this complaint, certain units of said toll plants and instruments have been retired. Units so retired have been written out of the plant accounts at the amount at which such units had been recorded therein, and the same amount, less any salvage resulting from the retirement, has been charged concurrently to the depreciation reserve.

35. Out of the toll plant purchased from the American Company in 1925, 1926, and 1928 at a cost of $5,973,441.47 as set forth in paragraphs 7 to 10 inclusive of this complaint, there remained in the plant accounts of the plaintiff, as of January 1, 1937, toll plant having an estimated book cost to the plaintiff of $2,971,058.99, and, as of January 1, 1942, toll plant having an estimated book cost to the plaintiff of $2,611,586.39. Out of the instruments purchased from the American Company in 1927 at a cost of $6,661,238.91 as set forth in paragraphs 11 and 12 of this complaint, there remained in the plant accounts of the plaintiff, as of January 1, 1937, instruments having an estimated book cost of $2,433,105.41, and, as of January 1, 1942, instruments having an estimated book cost of $630,279.13.

Reclassification of Accounts Made by the Plaintiff After the Effective Date of the Commission's Uniform System of Accounts

36. Upon the taking effect of the Commission's Uniform System of Accounts, the plaintiff proceeded to reclassify its accounts relating to such of the toll plant acquired from the American Company in 1925, 1926, and 1928, as remained in plaintiff's plant accounts as of January 1, 1937. Plaintiff recorded in Account 100.1 "Tele-

phone plant in service" the sum of $2,487,083.16, this being the book cost of such property to the American Company as appear-
19 ing on the books of the American Company at the time of the sale to the New York Company. Plaintiff also recorded in Account 100.4 "Telephone plant acquisition adjustment," the sum of $483,975.83, which was the amount by which $2,971,058.99, the estimated book cost of such property to the plaintiff as set forth in paragraph 35 of this complaint, exceeded the said sum of $2,487,083.16. The plaintiff did not reclassify the balances in its plant accounts relating to the instruments acquired from the American Company in 1927 for the reason that the instruments did not constitute "a substantially complete telephone system exchange, or toll line" within the meaning of Instruction 31.2-21 of the Commission's Uniform System of Accounts as set forth in paragraph 29 of this complaint.

The Proceedings Before the Commission Herein

37. By order dated June 16, 1942, the Commission instituted an investigation into the accounting performed by the plaintiff with respect to the purchases described in paragraphs 7 to 12 inclusive of this complaint, and directed the plaintiff to show cause "why the total amount of $4,166,510.57, representing amounts paid to American Telephone and Telegraph Company by the respondent for telephone property acquired from American Telephone and Telegraph Company on November 1, 1925, September 1, 1926, December 31, 1927, and December 31, 1928, in excess of book cost less the related depreciation and amortization reserves, as reflected on the books of American Telephone and Telegraph Company and its Long Lines Department, should not be charged to New York Telephone Company's Account 413, 'Miscellaneous debits to surplus,' with concurrent entries to such accounts as may be appropriate in the light of the accounting performed at the time of and since the respective dates of the acquisitions of such telephone property." A copy of said order is annexed hereto marked "Exhibit D" and made a part hereof. The plaintiff herein filed an answer to said order to show cause, as required.
20 A copy of said answer is annexed hereto marked "Exhibit E" and made a part hereof. Thereafter hearings were held by the Commission together with the New York Public Service Commission which had instituted a prior general investigation into the accounts of the plaintiff. On June 22, 1943, the Commission adopted a proposed report in said proceeding. The plaintiff filed exceptions to said proposed report. Thereafter, on September 22, 1943, oral argument upon such exceptions was had

before the full Commission. On December 14, 1943, the Commission adopted the Order complained of in this action.

38. The Order requires the plaintiff to debit its surplus account in the sum of $4,166,510.57, this being an amount equal to the excess of the amount paid by the plaintiff to the American Company for the toll plant and instruments purchased in the years 1925, 1926, 1927, and 1928, over the amount found by the Commission to represent the net book cost of such property on the books of the American Company at the time of said purchases. The Commission does not and could not base this requirement upon the provisions of its Uniform System of Accounts with respect to the reclassification of the balances existing in plaintiff's various accounts as of January 1, 1937, the effective date of said Uniform System of Accounts. Instead the Commission bases its requirement upon a determination that the accounting originally performed by the plaintiff was erroneous to the extent that plaintiff recorded any investment in the property acquired in excess of the net book cost of such property to the American Company, regardless of the amount paid by the plaintiff or the structural value of such property, and that this alleged error must be corrected even with respect to property which had been retired before January 1, 1937. The Order further requires the plaintiff to write off the entire amount which plaintiff had recorded in Account 100.4, as set forth in paragraph 36 of this complaint, as representing the excess of the cost of the toll plant acquired from the American Company which survived as of January 1, 1937, over the original cost thereof to the American Company; to increase the
21 amount at which the instruments, estimated by the Commission to be surviving as of December 31, 1941, are recorded in plaintiff's plant accounts, to an amount equal to the original cost of such instruments to the American Company; and to credit to depreciation reserve as of December 31, 1941, the sum of $3,879,957.94, this being the balance remaining after deducting from the debit of $4,166,510.57 required to be made to surplus, the excess of the credit to Account 100.4 arising from the reversal required to be made of the entries in that account with respect to the toll plant over the debit to Account 100.1 arising from the entries required to be made in that account with respect to the instruments, as above set forth.

39. On January 17, 1944, the plaintiff filed a petition with the Commission setting forth its intention to institute this action and praying that the Commission extend the time for the submission of proof as to the making of the entries required by its said order of December 14, 1943, to a date 30 days after the final determination herein, upon condition that plaintiff transfer from its Account 181, "Unappropriated surplus" to Account 180, "Surplus reserved,"

with appropriate notation, and maintain in said Account 180 during the pendency of this proceeding, the amount of $4,166,510.57 required by the Commission to be charged by plaintiff to its surplus account. On January 25, 1944, the Commission made an order upon said petition. Copies of said petition and order are annexed hereto marked, respectively, "Exhibits F and G," and made a part hereof.

Necessity of and Grounds for Relief From the Commission's Order

40. The Order requires plaintiff to charge its surplus account because of the purchase of the property here in question, when in fact the plaintiff suffered no loss upon the purchase of said property; requires the plaintiff to increase its depreciation reserve, which is already adequate; prevents the plaintiff from re-
22 cording in its property accounts and from amortizing through its expense accounts the excess of the amount paid for toll plant acquired by the plaintiff from the American Company which remained in plaintiff's plant accounts as of January 1, 1937, over the original cost of the toll plant to the American Company, although the amount so paid was not in excess of the value of the property acquired, and represented an investment by the plaintiff in assets of continuing value and in depreciable telephone plant; and generally requires plaintiff to misstate its accounts, and particularly its surplus account and its depreciation reserve, so that plaintiff's accounts will no longer reflect the plaintiff's actual investment nor the value thereof, but will conceal the amount of said investment.

41. Plaintiff is required to make a large number of financial reports to the Commission, to the Public Service Commissions of New York and Connecticut, to various tax authorities both federal and state, to the Securities and Exchange Commission, to the New York Stock Exchange, to the holders of its Series C 3% Bonds, and to investors generally. Unless the Order is enjoined, set aside, annulled and suspended by this Court, plaintiff will be required in such reports as well as in its corporate records, to misstate and misrepresent the facts as to its assets, surplus, reserves, expenses and income to regulatory authorities, to its bondholders, and to the public.

42. The Order is not supported by substantial evidence, is entirely at odds with fundamental principles of correct accounting, is beyond the statutory power and authority of the Commission, and is illegal and void, for the following reasons among others:

a. The Order requires the correction of an alleged error in plaintiff's accounting, although no error was made and such

accounting was in accordance with the requirements of the Uniform System of Accounts for Telephone Companies pre-
23 scribed by the Interstate Commerce Commission, to which plaintiff was subject at the date when the transaction occurred:

b. The Order requires accounting for property purchased from an affiliated company, at a date prior to the effective date of the Federal Communications Commission's Uniform System of Accounts for Telephone Companies, in a bona fide transaction and at a fair price, which is wholly different from the accounting for property purchased from a company not so affiliated, although no provision of the Uniform System of Accounts for Telephone Companies prescribed by the Interstate Commerce Commission which was in effect at the time of the transactions here in question, or of the later revision of said System, or of the Uniform System of Accounts for Telephone Companies prescribed by the Federal Communications Commission, makes any distinction between purchases from an affiliated company and purchases from a company not so affiliated;

c. The Order prevents the plaintiff from showing in its accounts the facts as to the purchases of property made by it from the American Company as set forth in this complaint, and requires the plaintiff to account for the said purchases on a basis which will not reflect either the plaintiff's actual investment in the property acquired or the value thereof;

d. The Order compels the plaintiff to rewrite its accounts as if a rule of substantive law required that a purchase of property from an affiliated telephone company must be at the net book cost of the selling company or that a purchase on any other basis must be disregarded as "fictitious," although no such rule of substantive law existed at the time of the transactions here in question, or now exists, and although the Commission has not been vested with power to established any such rule of substantive law either prospectively or retroactively;

24 e. The Order prescribes a rule of accounting to be made retroactively effective with respect to transactions executed prior to the effective date of the Commission's Uniform System of Accounts and of the Communications Act of 1934;

f. The Order prescribes a rule of accounting to be made retroactively effective to a date when plaintiff's accounts were prescribed by the Interstate Commerce Commission, as the duly authorized agency of the Government, and the rule now sought to be made retroactively effective by the Commission is at variance with the accounting so prescribed by the Interstate Commerce Commission;

g. The Order does not direct a reclassification of the balances existing in plaintiff's accounts as of January 1, 1937, the effective date of the Commission's Uniform System of Accounts for Telephone Companies, but requires that certain of said balances be written off to plaintiff's surplus account and that a further write-off be made to plaintiff's surplus account in respect of property which had been removed from plaintiff's plant accounts and charged to its adequate depreciation reserve prior to the effective date of said Uniform System of Accounts;

h. The Order requires accounting which is contrary to the Commission's Uniform System of Accounts for Telephone Companies as construed by this Court and in "the administrative construction binding upon the Commission in its future dealings with the companies" filed by these defendants in the Supreme Court of the United States, in the suit initiated in this Court entitled, "American Telephone and Telegraph Company, et al., plaintiffs, against United States of America and Federal Communications Commission, defendants, In Equity No. 81-366," to which suit this plaintiff and these defendants were adverse parties;

i. The Order requires plaintiff to increase its depreciation reserve, although the undisputed evidence showed that plaintiff's depreciation reserve was adequate;

j. The Commission denied the plaintiff a fair hearing, particularly by depriving plaintiff of the opportunity to demonstrate fully that the amount paid by the plaintiff for the toll plant and instruments acquired by the plaintiff from the American Company did not exceed the value of the property so acquired; and

k. For the reasons above set forth the Order deprives the plaintiff of its liberty and property without due process of law in violation of the Fifth Amendment of the Constitution of the United States.

43. Plaintiff is advised and therefore alleges that if the Order is complied with, plaintiff will for the reasons and in the manner stated in this complaint suffer irreparable injury and damage, and that if the Order is not complied with, unless plaintiff is afforded the protection by permanent injunction which this Court alone is competent to grant, plaintiff and its officers and employees will under the terms of the Communications Act of 1934 and particularly under Sections 220, 501, and 502 thereof, be subjected to a multiplicity of suits and criminal prosecution and fines and penalties.

Wherefore, plaintiff prays:

(1) That a summons issue under the seal of this Honorable Court and a copy of said summons and of this complaint be served upon the United States and the Federal Communications Com-

mission as prescribed by Rules 4(d)(4) and 4(d)(5) of the Federal Rules of Civil Procedure.

26 (2) That this Court convene a specially constituted court of three judges as required by Tit. 28, Sec. 47, Code of Laws of the United States.

(3) That this Court adjudge, order and decree that said Order of the Commission is and has at all times been beyond the lawful authority of the Commission and in violation of the legal rights of the plaintiff and wholly illegal and void and that said order be permanently enjoined, set aside, suspended and annulled, and the enforcement thereof permanently restrained and enjoined.

(4) That plaintiff may have such other and further relief in the premises as to equity and justice may appertain and as may be deemed by this Court to be adequate and proper under the circumstances.

RALPH W. BROWN,
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New York, N. Y.,

FRANK A. FRITZ,
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New York, N. Y.,

HENRY J. FRIENDLY,
Office and P. O. Address, 31 Nassau Street,
New York, N. Y.,
Attorneys for New York Telephone Company.

27 [*Duly sworn to by James W. Hubbell; jurat omitted in printing.*].

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28 *Exhibit A to complaint*

Before the Federal Communications Commission, Washington 25, D. C.

Docket No. 6329—P—30.

IN THE MATTER OF NEW YORK TELEPHONE COMPANY ACCOUNTING

Appearances; Edward L. Blackman, Esq., Ralph W. Brown, Esq., John H. Machan, Esq., and Frank A. Fritz, Esq., on behalf of New York Telephone Company; Harry Hertzoff, Esq., on behalf of the City of New York; R. J. McVeigh, Esq., and John T. Ryan, Esq., on behalf of the Public Service Commission of the State of New York; Daryal A. Myse, Esq., and Harold J. Cohen, Esq., on behalf of the Federal Communications Commission.

Report of the Commission

(Commissioner Case not participating)

This proceeding was initiated by order of the Commission on June 16, 1942. The Order instituted a general investigation into the accounting performed and the accounts, records, and memoranda kept by New York Telephone Company (hereinafter sometimes referred to as "New York"), at the time of and during
29 the period since all of its several acquisitions of telephone property, with respect to and as a result of such acquisitions. The Order made New York respondent and required it to show cause why the amount of $4,166,510.57 should not be charged to respondent's account 413, "Miscellaneous debits to surplus," with concurrent entries to such accounts as may be appropriate in the light of the accounting performed at the time of and since the respective dates of the four acquisitions with which such amount was associated. It was stated in the Order that the amount of $4,166,510.57 represented payments to American Telephone and Telegraph Company (hereinafter sometimes referred to as "A. T. & T.") by New York for telephone property acquired from A. T. & T. on November 1, 1925, September 1, 1926, December 31, 1927, and December 31, 1928, in excess of the book cost less the related depreciation and amortization reserves, as reflected on the books of A. T. & T. and its Long Lines Department.[1]

The order of June 16, 1942, also suspended all charges to operating expense accounts made by New York on and after January 1, 1942, for the purpose of, or in conjunction with, amortizing or otherwise disposing of amounts included in its Account 100.4 "Telephone plant acquisition adjustment," pending submission of proof by respondent of the propriety and reasonableness of such charges; and ordered respondent to cease and desist from making any such charges pending submission of such proof. An investigation was also ordered instituted to determine whether respondent or any of its officers and directors have violated the provisions of Account 100.4 (c),[2] Account 614,[3] Commission Order No. 60[4] or Section 220 (g) of the Communications Act of 1934. Respondent and each of its officers and directors were required to file
30 verified answers. Appropriate notice was given to the State Commissions having jurisdiction with respect to New York

[1] The Long Lines Department of A. T. & T. operates a nation-wide system of interstate toll line circuits. A separate set of accounts is kept to reflect the separate operations of the Long Lines Department.

[2] Section 31.100: 4 of the Commission's Rules and Regulations.

[3] Section 31.614 of the Commission's Rules and Regulations.

[4] Adopted July 12, 1939.

and to the National Association of Railroad and Utilities Commissioners. Although a hearing is not a prerequisite to action by the Commission under Section 220 of the Act, a hearing was ordered, with provision for its conduct jointly with hearings involving similar matters before the New York and Connecticut State Commissions. Under Section 220 of the Act respondent has the statutory burden of justifying the accounting entries questioned by the Commission. (Cf. Re Additional Charges to Operating Expense Account 672 (Relief and Pensions), F. C. C. Docket No. 5188, Decided December 2, 1942.)

On January 25, 1938, the New York State Public Service Commission had instituted its Case No. 9436 by an order of investigation into the books, records, and accounts of New York and as to its entries reflecting the acquisition of property acquired from other telephone companies. Hearings before that Commission had been held in February, 1938, and October, 1939, and the matter was set down for further hearing at the same time and place as the hearing ordered by this Commission in this proceeding. Joint hearings in both proceedings were held before Commissioners Walker and Wakefield, of this Commission, and Commissioners Maltbie and Van Namee of the New York State Public Service Commission, beginning July 30, 1942, and continuing intermittently to December 11, 1942. Proposed Findings of Fact and Conclusions and a supporting Brief were filed by New York. The Commission adopted a Proposed Report on June 22, 1943. Exceptions thereto and a supporting brief were filed on behalf of New York and its officers and directors, and oral argument was requested, which was thereafter held before the Commission en banc.

The New York State Public Service Commission is concurrently issuing its Report and Order in its proceeding. The conclusions reached by the New York Commission are generally similar to those in this Report and accompanying Order.

31 Among the twenty-two or more acquisitions of telephone property prior to January 1, 1937, reported by New York and covered by the Commission's investigation order of June 16, 1942, only four are involved in the show cause provisions of the order. These four were property acquisitions from A. T. & T. The amounts of money involved therein are a major portion of the total amount involved in all of New York's telephone property acquisitions from predecessor telephone companies. The hearings which were held herein were directed to these four acquisitions, and this report deals with the merits of the accounting performed with respect to those particular acquisitions only.

A. T. & T. has at all times material to this proceeding controlled New York through ownership of all of New York's common stock.

The four property acquisitions involved herein consisted of toll line properties and telephone instruments. The toll line properties were outside toll plant, principally poles, wires, and cables. In addition to telephone exchange service, New York furnishes both interstate and intrastate message toll service throughout New York State. At one time, A. T. & T., which conducts nationwide operations, also furnished both interstate and intrastate toll service in New York State. In the twenties, A. T. & T. decided to withdraw from intrastate toll business in New York State, and as a part of this plan, it transferred its intrastate toll business in New York State to New York. In connection with this transfer of the business, A. T. & T., in 1925 and 1926, made two of the four property transfers to which the Commission's show cause order of June 16, 1942, was directed. The third toll property transfer involved herein was one made in 1928, when a small amount of toll plant was transferred by A. T. & T. to New York in connection with the transfer by A. T. & T. to New York of certain interstate toll business. Much of the property acquired by New York in these three transfers was in the form of an additional interest in toll plant which was, prior to such acquisition, owned jointly by New York and A. T. & T. Portions of such acquired
32 property had been originally constructed by New York for A. T. & T., New York billing A. T. & T. for the cost of the construction, and A. T. & T. placing the property on its books at that cost. Those portions of the jointly-owned property constructed by New York, and as to which ownership was retained by New York, were recorded on New York's books at original cost of construction. During this same period, toll properties were similarly transferred from New York to A. T. & T.

The fourth property transfer to which the Commission's show cause order of June 16, 1942, was directed was that of the telephone "instruments," on December 31, 1927. In 1927, A. T. & T. decided to transfer ownership of the instruments to New York, as well as to its other Associated Companies, and on December 31, 1927, A. T. & T. transferred to New York the instruments then in the service or in the supplies of New York. Prior to that time, A. T. & T. had retained ownership of three essential parts of the telephone station used by the public. These parts were the transmitter, receiver, and induction coil, and are designated collectively as "the instruments." The other parts necessary for a complete telephone station, such as the stand, bell box, etc., were owned by New York. A. T. & T. furnished and maintained the instruments under a "license contract" between it and New York, similiar to that in effect between A. T. & T. and each of its other associated companies. Under this contract, which also covered other matters, New York paid A. T. & T. a specified percentage

of its gross revenues, 4% in 1927. The license contract fee was, when the instruments transfer was made, reduced from 4 to 2% of New York's gross revenues.

The above four transfers of property did not involve any change in the physical character of the plan involved, in the service rendered to the public, or the use of the plant in rendering the service. These transactions resulted in the transfer of certain expenses formerly comprised in operating costs of A. T. & T. to operating costs of New York, together with fixed charges and taxes connected with the ownership of the property; and,
33 as an offset, New York retained certain revenues it formerly turned over to A. T. & T.

The amounts involved in each of the above four property transfers are shown in Tables A and B, below.[5] In Table A are shown the book cost to A. T. & T., the related book depreciation and amortization reserves, and the net book cost to A. T. & T., with respect to each of the four property transfers, as of the time when such transfers occurred.[6]

TABLE A.—*Book Cost and Net Book Cost to A. T. & T. of Property Transferred to New York*

Property group	Year of transfer	Book cost to A. T. & T.	Related depreciation and amortization reserves	Net book cost
Toll line property	1925	$5,010,340.19	$801,858.95	$4,208,481.24
Toll line property	1926	95,924.66	14,449.20	81,475.46
Toll line property	1928	28,077.64	4,144.78	23,932.86
Total		5,134,342.49	820,452.93	4,313,889.56
Telephone instruments	1927	8,135,224.98	3,980,944.73	4,154,280.25
Grand Total		13,269,567.47	4,801,397.66	8,468,169.81

34 In Table B, below, are shown, with respect to the four property transfers, the net book cost to A. T. & T. of the properties, the amounts that New York entered in its asset accounts as its book cost, and the "profit" to A. T. & T., consisting of the excess of the amounts so entered, over the net book cost to A. T. & T.

[5] There are terms used in Table A, and throughout this report, whose meaning should be clearly understood. The term "book cost" is the amount at which property is carried (whether rightly or wrongly) in the company's asset accounts. It may be in a given instance the original cost; it may be a price paid which is different from original cost; or it may be some other figure dependent on vagaries of bookkeeping. The term "net book cost" means the book cost minus the amount of depreciation and amortization reserves shown on the books which is related to the property for which the book cost is shown.

[6] For the purposes of this report only, it is assumed that the figures in the record herein for book cost to A. T. & T. of the plant in question represent the original cost of the plant, and that the book depreciation and amortization reserve figures determined by A. T. & T. and shown in the record as applicable to the plant transferred to New York are correct.

TABLE B.—*A. T. & T. Net Book Cost, Price and "Profit" on Property Transferred*

Property group	Date of transfer	Net book cost to A. T. & T.	Recorded book cost to New York	Excess or "profit" to A. T. & T.
Toll line property	1925	$4, 208, 481. 24	$5, 831, 884. 78	$1, 623, 403. 54
Toll line property	1926	81, 475. 46	97, 310. 39	15, 834. 93
Toll line property	1928	23, 932. 86	44, 246. 30	20, 313. 44
Total		4, 313, 889. 56	5, 973, 441. 47	1, 659, 551. 91
Telephone instruments	1927	4, 154, 280. 25	6, 661, 238. 91	2, 506, 958. 66
Grand Total		8, 468, 169. 81	12, 634, 680. 39	4, 166, 510. 57

In recording on its books each of the above four property transfers, A. T. & T. credited its plant account with the amount of its book cost shown in Table A above, and debited its depreciation and amortization reserves with the amount shown for those reserves in Table A. In each case, New York recorded the transfer by entering in its plant acounts the total amounts of the "prices" assigned by A. T. & T. for the properties acquired. New York recorded no amount with respect thereto in its depreciation or amortization reserve accounts. In each of the four cases, the amount recorded by A. T. & T. as received from New York in excess of the net book cost to A. T. & T. of the plant transferred was credited by A. T. & T. to surplus accounts as profit on the transaction.[7] These excess amounts, or "profits," as shown in Table B, totalled $4,166,510.57. The Commission's order of June 16,
35 1942, herein, directs New York to show cause why this total amount should not be charged to New York's surplus.

This difference of more than four million dollars between the net book cost to A. T. & T. of the properties transferred and the amounts recorded in the books of New York is attributable to the fact that the original cost of the property transferred, and the depreciation which had been accrued therefor on the books of A. T. & T., were ignored. With respect to the three transfers of toll properties, the accounting was on the basis of "structural value" as of the time of the transfers, or estimated reproduction cost new minus a depreciation allowance, as determined by appraisals. The recorded cost of the instruments to New York was based upon the average price of new instruments purchased by A. T. & T. from the Western Electric Company (a subsidiary of A. T. & T.) during the first nine months of 1927, less 20% as representing the used condition of the instruments.

[7] The amount associated with the instrument transaction was credited by A. T. & T. to a special contingency surplus reserve account.

Prior to 1937 it appeared that none but routine entries were made by New York with respect to the plant transferred to it by A. T. & T. Although this property had been recorded in New York's plant accounts at amounts which purported to reflect all existing depreciation, and the property had a relatively short remaining life, special depreciation rates were not applied to the amounts recorded in New York's plant accounts for this property, the current depreciation rates applicable to the respective classes of plant being applied to these amounts as long as the property remained in service. From time to time, as portions of such acquired property were retired from service, estimated amounts, based upon the book cost to New York ("structural value" in this case) of the property, were retired on New York's books by credits of such amounts to its plant accounts, and debits of corresponding amounts (with allowance for salvage) to its depreciation or amortization reserves.

On January 1, 1937, the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies
36 became effective [8] and its provisions are applicable to New York as a Class A telephone Company. New York was thus required to reclassify the amounts recorded in its then existing accounts to conform with the provisions of such Uniform System of Accounts.[9] Under "Balance Sheet Accounts—Investments" the System provides that Account 100.1, "Telephone plant in service," [10] shall include "the original cost of the company's property used in telephone service at the date of the balance sheet as classified under Accounts 201 and 277, inclusive;" and that Accounts 100.2 and 100.3 [11] shall include the original cost of telephone plant under construction and property held for future telephone use, respectively. The system further provides that Account 100.4,[12] "Telephone plant acquisition adjustment," shall include amounts "representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depre-

[8] Part 31 of the Commission's Rules and Regulations. On June 19, 1935, the Telephone Division of the Commission (see 1 F. C. C. 3 and Order No. 20, 4 F. C. C. 41) adopted its Order No. 7–C which prescribed a Uniform System of Accounts for Telephone Companies having average annual operating revenues exceeding $50,000, effective January 1, 1936 (1 F. C. C. 45). The operation of Order No. 7–C was stayed because of the proceeding in the case of American Telephone and Telegraph Company v. United States, in which the Uniform System of Accounts was attacked by A. T. & T. After the decision of the Supreme Court of the United States on December 7, 1936 (299 U. S. 232), the Telephone Division adopted its Order No. 7–D amending its Order No. 7–C in certain respects and making the amended System of Accounts effective January 1, 1937 (3 F. C. C. 9).

[9] Section 31.01–2 (e) of the Commission's Rules and Regulations.

[10] Section 31.100 : 1 of the Commission's Rules and Regulations.

[11] Section 31.100 : 2 and 31.100 : 3 of the Commission's Rules and Regulations.

[12] Section 31.100 : 4 of the Commission's Rules and Regulations.

ciation and amoritization of the property acquired." "Original cost" as used in Accounts 100.1 to 100.4, inclusive, is defined in the System of Accounts by Section 31.01-3(x) of the Rules and Regulations as "the actual money cost of (or current money value of any consideration other than money exchanged for)
37 property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors."[13] New York was thus obliged to recognize specifically the existence of amounts in its plant accounts which up to that time had not been stated in terms of original cost. The principal amounts to be so recognized were those reflecting plant surviving from the four transfers previously described.

New York has not reclassified on an original cost basis the amounts in its accounts associated with the transfer of the telephone instruments in 1927. It contends that under the provisions of Instruction 21 of the Uniform System of Accounts,[14] it was not required to reclassify these amounts. As of January 1, 1942, it was estimated by New York that approximately 9½ to 15% of the instruments transferred to New York in 1927 remained in service.

In reclassifying its accounts as of January 1, 1937, New York estimated, on the basis of the book cost to it (i. e., "structural value"), the amounts pertaining to the surviving toll plant transferred to it by A. T. & T. in 1925, 1926, and 1928. Next, the original cost of such surviving plan, as originally reflected on the books of A. T. & T., i. e., book cost to A. T. & T., was determined. The latter figures were set up in Account 100.1 of New York to represent the amount of such surviving property as "plant in service." The difference between this "original cost" and the "structural value" was placed in Account 100.4. This amount was $483,975.83. No amount was credited to New York's Account 171, "Depreciation reserve,"[15] in the process of reclassification. In connection, however, with New York's plan for disposition of amounts included in Account 100.4 as a result of the reclassification with respect to plant involved in the three toll property transfers and estimated as surviving, New York transferred in 1937 from its Account 171 to its Account 172, "Amortization
38 reserve,"[16] an amount which, when supplemented by future accruals over the estimated remaining life of the plant at the then current depreciation rates for the respective plant classes, would provide a reserve equivalent to the amount in question in Account 100.4 at the termination of the life of the property involved.

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[13] See Section 213(c) of the Communications Act of 1934.
[14] Section 31.21 of the Commission's Rules and Regulations.
[15] Section 31.171 of the Commission's Rules and Regulations.
[16] Section 31.172 of the Commission's Rules and Regulations.

Table C below shows the amounts which were involved in New York's reclassification of the toll properties transferred to it by A. T. & T. in 1925, 1926, and 1928.

TABLE C.—*Reclassification of Surviving Toll Plant Transferred to New York by A. T. & T.*

	(a) Book cost to N. Y. ("structural value") of plant acquired	(b) Estimated book cost to N. Y. of plant surviving as of Jan. 1, 1937	(c) Original cost of surviving plant (book cost to A. T. & T.)	(d) Difference (b-c) charged to account 100.4
1925 Transfer	$5,831,884.78	$2,843,934.61	$2,373,142.45	$470,792.16
1926 Transfer	97,310.39	91,428.42	[illegible]	R1,299.94
1928 Transfer	44,246.30	35,695.96	21,213.02	14,482.94
Total	5,973,441.47	2,971,058.99	2,487,083.16	483,975.83

NOTE.—R = Credit item.

The adjustments made by New York in its reclassification of the property involved in the three toll plant transfers were limited to the surviving toll property, and to the asset accounts. The fact that the amount of "plant in service" was slightly reduced in the process of classification was largely accidental. Since the old entries reflected a depreciated appraisal figure and the new entries represented undepreciated original cost, and both were the result of estimates, it might easily have happened that the new amounts would have been greater than the old. This happened with respect to the 1926 transfer, which was increased in book cost by $1,299.27 (see Table C above), despite the fact that the amount paid by New York for this property in 1926 was $15,834.93 more than its net book cost to A. T. & T. (See Table B above.)

39 In 1938 New York began amortizing the amounts included in its Account 100.4 by charges and credits to its operating expense Account 614, "Amortization of telephone plant acquisition adjustment," with concurrent entries to its Account 172. From time to time, when portions of the acquired plant were retired, amounts in Account 100.4 were written out of that account with a concurrent entry to Account 172. These amortization charges to Account 614 from January 1, 1942, were the charges which were suspended, and which New York was ordered to cease and desist from making, by the Commission's Order of June 16, 1942, herein.

The accounting performed by New York with respect to the four property transfers involved herein was improper. This accounting resulted in a purely inflationary write-up of New York's plant accounts by the amounts entered therein in excess of the net book cost to the A. T. & T. of the plant involved. These

excess amounts represented a "profit" to A. T. & T. Since New York was then, as it is now, fully subject to control by A. T. & T., the intercompany profits to A. T. & T. resulting from the affiliated company transfers of property involved herein are fictitious or paper increments, and are as unreal as profits from interdepartmental transactions. These intercompany profits to A. T. & T. resulted from transfers of property which did not involve any change in the physical character of the properties involved or in their use, but only changes in the business arrangements between two affiliated companies. The transfer of property from the parent A. T. & T. to its subsidiary New York should not be permitted to convert the excess amounts over A. T. & T.'s net book cost from a fictitious intercompany profit to an investment in assets by New York. That this intercompany profit lacks reality was recognized by accounting witnesses presented by New York, who testified that the consolidated surplus of A. T. & T. and its subsidiaries, including New York, should be corrected for inflation due to intercompany transfers of property such as those involved herein, by the elimination from the consolidated surplus of the amount of the intercompany profit. If the amounts of such fictitious intercompany profits are allowed to remain in New York's accounts, they may become real profits to the affiliated companies by improper inclusion as a part of the cost of service. The possible scope of the effects of such accounting as is here in question is further illustrated by the fact that transfers of property were made in both directions between New York and A. T. & T. at prices in excess of the net book cost of the respective transferor company, and accounted for in a manner similar to that employed with respect to the four transfers here in question. The result was that the combined surplus of the affiliated companies was increased, not because of any increase in income or property, not because of any change in the service rendered, but simply because of the accounting performed.

The passage of time can lend no sanction to improper accounting. Whenever errors in accounting are discovered they should be corrected. The inflationary write-ups found herein should never have been recorded in New York's accounts, and should now be forthwith eliminated from New York's accounts.

New York contends that the amounts paid to its parent company, A. T. & T., as a result of the acquisitions of telephone property here under consideration were fair and reasonable and were not in excess of the fair and reasonable value of the property acquired; that after reclassifying its accounts, as of January 1, 1937, as outlined above, appropriate amounts were entered in its Account 100.4 and the entries to operating expense accounts for

the purpose of amortizing amounts so included in Account 100.4 have been made in accordance with a plan approved by the Commission; and that therefore no other entries, and specifically no entry to its surplus Account 413, in the amount of $4,166,510.57 are required or appropriate under the Commission's Uniform System of Accounts. Respondent also asserts that the recording in its plant accounts of the full amounts paid to A. T. & T. was required by the accounting rules prescribed by the Interstate Commerce Commission, and in effect at the time of the respective prop-
41 erty acquisitions; and that since the "structural value" of the property, as measured by reproduction cost new less actual depreciation, was equal to or more than such amounts so paid, the "prices" were fair and reasonable.

All of these contentions ignore the important fact that New York was and is a wholly owned subsidiary of A. T. & T., and therefore fully subject to A. T. & T.'s control. This fact makes the fairness and reasonableness of the "prices" paid in such a transfer of property between such affiliated companies completely unrealistic as a measure of investment in plant. There was and could be no arms'-length bargaining between A. T. & T. and New York with respect to the amounts so paid. Any method of accounting which results in the inclusion in plant investment accounts of amounts based upon "values" agreed upon between a wholly owned subsidiary and its parent which are greater than legitimate net book cost to the transferor would nullify accounting from a regulatory standpoint. The full ultimate impact of such inflationary elements in the plant accounts is in time improperly reflected in the depreciation expense account as an alleged operating cost, unless, by proper regulatory requirements, the balance sheet is cleared, or in the first instance is kept free, of such inflationary elements. Accounting, for purposes of efficient regulation of public utilities, must be firmly grounded on the cost principle, and if the investment recorded in the accounts is to have some relationship to the actual investment dedicated to the public use by an affiliated group of companies, such agreed "values" must not be allowed to exist as a distortive element in their investment accounts. Certainly such "values" cannot be represented by an estimate of such an inherently speculative nature as reproduction cost less depreciation, or "structural value." Otherwise transfers of property between affiliated companies would provide a device to establish write-ups to any desired "structural value." "Structural value" at best requires conjecture, involving as it does estimates as to what certain property might have cost to reproduce, assuming it were to be reproduced in new
42 condition at the prices in effect at the time when the estimates are made; and further involving estimates as to

existing depreciation in the property, based on obsolescence and inadequacy, as well as wear and tear.[17]

The effects of using "structural value" as the basis for the property transfer may be illustrated by a comparison of book figures with the "structural value" figures for the two major transactions of the four considered herein, namely, the 1925 toll property transfer and the transfer of the instruments. Table D, below, shows such a comparison.

TABLE D.—*Comparisons of Book Cost, Reproduction Cost, and Depreciation Figures*

	Toll lines (1925 transfer)	Instruments	Total
Book figures of A. T. & T.:			
Book cost of A. T. & T	$5,010,340.49	$8,135,224.98	$13,145,565.17
Depreciation Reserve	801,858.95	3,980,941.73	4,782,803.68
Net Book Cost	4,208,481.24	4,154,280.25	8,362,761.49
Appraisal for Transfer:			
Reproduction Cost	6,693,499.53	8,326,548.64	15,020,048.17
Depreciation Allowance	861,614.75	1,665,309.73	2,526,924.48
Net, or "Structural Value"	5,831,884.78	6,661,238.91	12,493,123.69

In comparing the above figures, it will be observed that the reproduction cost of the toll lines exceeds book cost by more than 33 per cent, but that the depreciation allowance on the toll lines in the appraisal is only slightly greater in amount than the depreciation reserve accrued on the books of A. T. & T. In other words, the depreciation is relatively much lower in the appraisal than
43 on the books. In the case of the instruments, the depreciation allowance in the appraisal, despite its applicability to a higher base, is less than half the amount shown on the books. This may be explained by the fact that the book depreciation purports to take account of all causes of retirement, whether physical deterioration, obsolescence, inadequacy, or other cause, whereas the appraisal depreciation tends to be confined largely to observed physical deterioration.

It will also be observed in Table D above that the "structural value" of the toll lines, although representing depreciated property, is actually greater than the book cost new to A. T. & T. of the property. This means that where the "structural value" was

[17] The highly speculative nature of estimates of reproduction cost less depreciation is illustrated by the following defects in respondent's showings and offers of proof in this respect: The reproduction cost new figures were based in part upon prices of the Western Electric Company, Inc., another subsidiary of A. T. & T., without elimination of Western Electric profits. Such reproduction cost figures were based upon costs to A. T. & T., although in at least some instances construction costs of New York were lower.

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entered in the asset accounts of New York, the book cost of the property was written up, which accounted directly for a part of the inflation. The remainder of the inflation as to this property consists of the failure of New York to enter an appropriate credit in the depreciation reserve. With respect to the instruments, the amount entered by New York as book cost after the transfer was less than the book cost to A. T. & T. This means that as to the instruments, the entire inflation is represented not by an excess in the asset account but by the failure of New York to make due credit to its depreciation reserve. As previously found, New York made no credit to this reserve, with respect to the instruments.

New York attempts to justify the accounting followed by it with respect to the four property transfers involved herein on the ground that such accounting was required by accounting rules prescribed by the Interstate Commerce Commission and in effect at the time of the transfers. With respect to the toll property acquisitions, New York asserts that the accounting performed by it at the time was required by Instruction 13 [18] of the Inter-
44 state Commerce Commission's Uniform System of Accounts for Telephone Companies in effect from January 1, 1913, and that with respect to the acquisition of the telephone instruments, Instruction 10 [19] of the Uniform System of Accounts, as interpreted in Case No. 30 of Accounting Bulletin No. 11 issued by the Interstate Commerce Commission effective July 1, 1916, stated the required accounting.

New York's assertion that the accounting followed by it with respect to the four property transfers involved herein was required

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[18] Instruction 13 provided as follows:

"Plant and equipment and other property purchased.—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, Other Intangible Capital, and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts.

"Companies should be prepared to furnish the Commission, upon demand, a full report of the contract of acquisition, the consideration given therefor, the determination of the actual money value of such consideration if other than money, the appraisal, and the amounts charged to the respective accounts for each plant or other such fixed capital purchased. The purchaser is required to procure in connection with the acquisition of any such plant or other fixed capital all existing records, memoranda, and accounts in the possession or control of the grantor relating to the construction and improvement of such plant, and to preserve such record, memoranda, and accounts until authorized by law to destroy or otherwise dispose of them."

[19] Instruction 10 provided as follows:

"Costs to be actual money costs.—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. When the consideration actually given for anything with respect to which a charge is made to any fixed capital or other property account is anything other than money, the actual consideration should be described in the entry with sufficient fullness and particularity to identify it, and the amount charged should be the actual money value of such consideration at the time of the transaction."

by accounting rules of the Interstate Commerce Commission in effect at the time is not supported by the record. There is no provision in Instruction 10 or Instruction 13, or elsewhere in the Interstate Commerce Commission's Uniform System of Accounts for Telephone Companies in effect at the time, which specifically required or authorized the recording of property acquisitions from affiliates at any amount greater than the net book investment of the transferring affiliate. The four property transfers in-
45 volved herein were never submitted to the Interstate Commerce Commission for a ruling as to the propriety of the accounting performed, and no ruling was ever given by that Commission or its responsible accounting officials with respect to such accounting. As early as 1914, however, shortly after the effective date of the Interstate Commerce Commission's Uniform System of Accounts, the New England Telephone and Telegraph Company, an A. T. & T. subsidiary, and A. T. & T. requested rulings by the Interstate Commerce Commission as to whether Instruction 13 of the Interstate Commerce Commission's Uniform System of Accounts applied to the accounting for transfers of property between affiliated companies of the Bell System, the companies contending that it did not. The Interstate Commerce Commission replies stated specifically that Instruction 13 was not applicable to the affiliated company transfers submitted to it. Mr. C. D. Crandall, present Director of the I. C. C. Bureau of Accounts, and a member of that Commission's accounting staff for many years prior to 1925, confirmed the position of the Interstate Commerce Commission as stated in such correspondence. In numerous subsequent cases, the question of the propriety of the accounting to be performed with respect to similar property transfers between Bell System affiliated companies, including transfers to and from New York itself, was submitted to the Interstate Commerce Commission for ruling. Testimony presented by New York showed that in the period 1913 to 1932, both years inclusive, there were approximately 300 property transfers between Bell System affiliated companies involving a charge to the telephone plant account of \$50,000 or more; and that of these, approximately one-half were accounted for on the basis of a transfer of the book figures from the books of the transferor to those of the transferee, the remainder being accounted for on the basis of the "price" assigned for the property transferred. It was further testified that in every case in which the transfer was accounted for on the book figure basis, which included some cases of property transfers to or from New York, some of these being in the very period when the trans-
46 fers involved herein were being undertaken, the question of the propriety of this accounting was submitted to the Interstate Commerce Commission, and, without exception, written ap-

proval of such accounting was given by the responsible accounting officials of that Commission. The Bell System companies involved proceeded with their accounting on the basis of such approval. In these cases, as previously indicated, the Bell System companies urged the approval of the accounting on the basis of the transferor's book figures. In no case in which the property transfer was accounted for by the transferee on the basis of the cost to it, that is, the "price" fixed for the property (which might or might not have been equivalent to "structural value"), was the question of the accounting to be performed submitted to the Interstate Commerce Commission.

This Commission does not understand that it would be bound by such an accounting requirement of the Interstate Commerce Commission as that which New York contends herein to have existed.[20] In any event, however, this Commission is unable to find that such an accounting requirement did exist. To summarize findings set forth above, the Interstate Commerce Commission, in every case of about 150 submitted to it involving a charge to plant accounts of $50,000 or more, approved an accounting for the property transfer between Bell System affiliated companies on the basis of the transferor's book figures; and in no case did that Commission rule on the accounting by the transferee for a property transfer between Bell System affiliated companies which was on the basis of cost or "price" to the transferee. It further appears from the letters on behalf of the Bell System companies to the Interstate Commerce Commission submitting the question of the accounting for the Bell System transfers that those companies, including New York, recognized the soundness of accounting for such transfers on the basis of the transferor's book figures as
47 to the plant investment and related reserves. This Commission is unable to conclude that the above-cited Instructions 10 and 13 of the Interstate Commerce Commission's Uniform System of Accounts, with their emphasis on "actual money costs" or "actual money value," and the express application to property "purchased," were intended to apply to the accounting for transfers of property between affiliated companies in which there were mere record changes of ownership. This Commission is impelled to reject this conclusion particularly because it is unable to conclude that the Interstate Commerce Commission intended to sanction, or that the provisions of its Uniform System of Accounts did

[20] In Section 604 (a) of the Communications Act of 1934, as amended, it is recognized that this Commission may modify, terminate, supersede, or repeal any order, determination, rule, regulation, etc., of the Interstate Commerce Commission with respect to matters transferred by the Act from the jurisdiction of that Commission to this Commission, and such matters include jurisdiction over telephone accounting.

sanction, in any way any write-ups of asset accounts and inflation of surplus within an affiliated system.[21]

New York asserts that even if there were inflationary write-ups in connection with the four property transfers involved herein, as amounts in its accounts with respect to the property which was acquired from A. T. & T. have been retired from New York's plant accounts, the related amounts of the inflationary write-ups have been removed from its accounts, and that to that extent, charges to surplus are not now necessary or appropriate to eliminate such amounts. It is clear, however, that the inflation still remains in New York's books either in its assets accounts or
48 as a deficiency in its depreciation reserve account, or a combination of both. When New York retired portions of the property acquired from A. T. & T., New York's book cost was credited to its plant accounts, the same cost (aside from the effect of salvage) was debited to the depreciation reserve, and the resultant change in net book cost of plant was zero. Thus the effect of retiring an inflationary asset item was to create a deficiency in the depreciation reserve equal to the inflation formerly existing in the asset account. The deficiency in New York's depreciation reserve therefore results from the existence of debits made thereto and included therein in recording the retirement of portions of the acquired property in amounts in excess of the net book cost to A. T. & T. of such property. These debit amounts were included in New York's depreciation reserve account despite the fact that insufficient credits had been made to such reserve accounts for purposes of retirement of the property.

New York attempted to counter these conclusions with the contention that its depreciation reserve *as a whole* is now in excess of requirements and consequently the inflation introduced through the accounting for the transactions in question has been offset by an excess in the reserve resulting from other causes; and that,

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[21] It is of interest to note that the Uniform System of Accounts for Telephone Corporations prescribed by the New York Public Service Commission, effective January 1, 1912, as amended on March 17, 1921, contained the following provision (Section 7 of the General Instructions:

"Plant and equipment and other property purchased.—When any telephone line or part thereof (excepting new or used material and supplies) is purchased for a lump sum, an appraisal of the property so acquired shall be made, classifying the various constituent elements in the property according to the accounts prescribed by this Commission in its Uniform System of Accounts for Telephone Corporations. The actual money value of the consideration given for the plant or other property purchased shall be distributed to such accounts in accordance with the appraisal, but in no case shall the values assigned to tangible fixed capital accounts exceed the cost of reconstructing such plant and equipment at prices in effect at the time of purchase, *and when there is substantial identity of interest between the vendor and the vendee the values assigned to tangible fixed capital accounts shall not exceed the original cost of such property to the vendor. The estimated accrued depreciation on property purchased shall be set upon the books of the vendee as an offsetting liability to the cost of property so acquired.* * * * [Italics supplied.]

further, unless the Commission can show that the reserve as a whole is deficient no correcting entry which would increase the reserve can be required. But the question as to whether the depreciation reserve, taken as a whole, is adequate is irrelevant to the issues herein. No challenge is here being made to the adequacy of the depreciation reserve as a whole. This line of argument represents an attempt to offset one error by another. If New York's depreciation reserve is in excess of requirements, it means that New York has been making excessive charges to operating expenses for depreciation. A forgiveness of the 1925–1928 write-ups on the ground of their elimination by charges against the depreciation reserve would be the equivalent of permission to
49 establish corporate surplus out of accruals charged to operating expenses by a company under the guise of depreciation. New York is actually here trying to justify a transfer from its depreciation reserve to the corporate surplus of its parent, A. T. & T. New York's further contention, stated, above, is in effect a claim that it can make any improper entries which would reduce its depreciation reserve, and not be required to correct such entries unless a deficiency can be proved in the reserve as a whole. This amounts to a claim, about which no more need be said, that no individual accounting entries can be ordered to be corrected unless the Commission can prove that all the accounts involved are otherwise in order.

New York relies heavily on statements of the United States Supreme Court in American Telephone and Telegraph Company v. United States, 299 U. S. 232, and the record in that case, with respect to the disposition of items in Account 100.4. In this line of argument, however, New York assumes that the amounts in question were properly includible in Account 100.4 when it reclassified its accounts in 1937. Since the entries made at the time of the four property transfers involved herein were improper, New York should have eliminated them and corrected its books before reclassifying its accounts in 1937. The part played by the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder, was simply to call attention to an impropriety is accounts which should have been corrected even if the new system had not gone into effect. But if it were assumed, for the sake of argument, that the amounts in question were properly includible in Account 100.4, the Commission is unable to find from the circumstances any sound basis for concluding that the amounts of inflationary write-ups which occurred here in the accounting for property transfers between affiliated companies "represent an investment which the accounting company had made in assets of continuing value," or are "definitely

attributable to depreciable telephone plant," within the
50 meaning of the statement filed by the government with the
Supreme Court in the above-cited American Telephone and Telegraph Company case.[22]

New York has suggested that the separate creditors of the respective affiliated companies involved in a property transfer may suffer if any amount paid by the transferee over the net book cost to the transferor is required to be charged by the transferee to its surplus accounts. We find no merit in this suggestion. This report is not concerned with the prudence of the transfers, but only with the accounting to be followed therefor. The question of the prudence of the transactions would appear to be one between the creditors and the debtor companies. From the accounting standpoint, the requirement that property transferred between affiliates be recorded on the books of the transferee at net book cost to the transferor should serve as a restraint to the kind of speculative financing which has no place in a properly conducted public utility enterprise.

New York contends that it was denied a fair hearing. The record will show, however, that New York was given a full and fair hearing on the real issues. New York's complaint is actually that it was not permitted to flood the record with voluminous data irrelevant to the real issues. Thus, New York attempted repeatedly to present data as to the justification for the acquisition of the properties to which the accounting here in question related, the appraisal methods used, and the adequacy of the depreciation reserve as a whole. Many of these data was introduced into the record, but the presiding Commissioners eventually ruled
51 that no further testimony along these lines would be received. The irrelevance of such matters to the issues herein is clearly demonstrated in this report. It is clear from an examination of the record that no competent and material evidence concerning the real issues in this proceeding was rejected.

New York's amortization of the debit amounts included in its Account 100.4 by charges to its operating expense accounts, and its amortization of the credit amounts included in that account

[22] In view of the conclusion that the amounts here in question were not includible in Account 100.4, it is unnecessary to rule on the propriety of the accounting performed by New York on its assumption that Account 100.4 was to be used for the acquisition here in question. We point out, however, that Account 100.4 and the method to be followed under the System of Accounts in reclassifying the accounts with respect to property acquisitions, as outlined by Section 31.2–21 of the accounting Rules and Regulations of this Commission, specifically require that the amounts includible in Account 100.4 shall reflect the difference between (1) the original cost, after deduction of the appropriate reserve requirements for depreciation and amortization, and (2) the amounts paid. No distinction is made in the accounting rules as between acquisitions prior to January 1, 1937, and those after that date. Even on New York's assumption that Account 100.4 was to be used here, New York's failure to make any credit entries to Account 171 to reflect the reserve requirement for depreciation of acquired property, and to deduct the amount of such reserve requirement from original cost, in determining the amounts includible in its Account 100.4 resulted in the inclusion of insufficient amounts in that account.

by credits to its operating expense accounts, were begun in 1938 without any prior direction, authorization, or approval having been given to New York by this Commission. Such action was improper, even on the basis of New York's assumption that the amounts being so amortized were properly includible in Account 100.4. Subsection (c) of Account 100.4 requires that the amounts included in that account be disposed of, written off, or amortized as directed by the Commission. Account 614, the operating expense account to which such amortization charges and credits were made by New York, permits such charges or credits only when authorized by the Commission.[23] On July 12, 1939, the Commission adopted its Order No. 60 in which the Commission allowed all telephone companies to dispose of any debit amounts includible in Account 100.4 by charges to surplus, or by amortization over a reasonable period through charges to Account 323, "Miscellaneous income charges,"[24] without further direction or approval by the Commission. This order, however, also directed companies desiring another manner of disposition of such debit amounts to request "that the Commission approve the recommended disposition or direct appropriate disposition according to the circumstances involved in each transaction." Disposition of credit amounts was ordered to be "as the Commission may approve or direct."
52 Appropriate reservation was made to require subsequent disposition by charges to surplus or to alter the previously determined amortization periods.[25]

New York argues on the basis of correspondence between A. T. & T. and the Commission's staff that its amortization through operating expenses of amounts included in its Account 100.4 was performed pursuant to "tentative approval of the Commission," claiming specifically "that the Commission gave its approval to such amortization subject to the right reserved to it to order a different disposition of the amounts included in Account 100.4 if, upon subsequent inquiry, it should appear that other treatment would be appropriate." New York asserts, however, that the primary question now is whether or not such approval should have been given.

The Commission finds that no direction, authorization or approval has ever been given to New York by this Commission to

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[23] Account 614 reads as follows: "§ 31.614 Amortization of telephone plant acquisition adjustment.—This account shall be charged or credited each month with such amounts as may be authorized by the Commission to be included in operating expenses under a plan to amortize accounts in Account 100.4, 'Telephone plant acquisition adjustment.' Amounts so entered shall be charged or credited, as appropriate, to Account 172, 'Amortization reserve.'"

[24] Section 31.323 of the Commission's Rules and Regulations.

[25] Case 10, Accounting Circular No. 5 (August 16, 1939), Accounting Bulletin No. 1, of this Commission, also made it clear that net amounts in Account 100.4 resulting from debit and credit amounts relating to different transactions, could not be disposed of without direction or approval by the Commission.

dispose of amounts in Account 100.4 by amortization through charges or credits to Account 614, or any other operating expense account. As our findings herein show, no such direction, authorization, or approval would have been appropriate as to the property transfers considered in this report. Since the Commission's order of June 16, 1942, herein, suspending all amortizing charges to operating expenses with respect to amounts in New York's Account 100.4, New York has not submitted any data as to the propriety and reasonableness of such charges, other than those submitted herein regarding the three toll property transfers. We find that the amortization through operating expenses of the amounts included in New York's Account 100.4, which amortization was begun by New York in 1938, was in violation of the Commission's Accounting Rules and Regulations, particularly Subsection (c) of Account 100.4, Account 614, and Order No. 60. Such amortization entries as related to the amounts included in New York's Account 100.4 with respect to the property transfers involved herein were therefore improper for such reason, as well as for the reasons
53 previously set forth in this report. Complete rectification of such amortization entries between 1938 and January 1, 1942, by reversal thereof, will not be required because the amounts involved are relatively insignificant and the accounts for that period have been closed. The suspension by the Commission's order of June 16, 1942, herein, of amortizing charges to operating expense accounts made by New York on and after January 1, 1942, with respect to the remaining amounts included in New York's Account 100.4 should be continued, pending submission of proof by New York of the propriety and reasonableness of such charges, and the direction, authorization, or approval of the Commission. Considering, however, all the circumstances surrounding such violation, and the entries herein required to be made by New York, the Commission is of the opinion that no further action by it with respect to such violation is required, and the investigation directed thereto will be terminated and dismissed.

Conclusions

We are of the opinion and we find and conclude that:

(1) Respondent has failed to show that the amount of $4,166,-510.57 should not be charged to its Account 413, with concurrent entries to appropriate accounts; and we further find and conclude that such amount shall be charged (debited) to its Account 413;

(2) Concurrently with such charge to Account 413, entries shall be made (a) to eliminate, by appropriate entries to respondent's

Account 100.4, the amounts presently included in that account, associated with New York's acquisitions from A. T. & T. on November 1, 1925, September 1, 1926, and December 31, 1928; (b) to eliminate the amounts presently included in Account 172, associated with such acquisitions, with contra entries to Account 171; (c) to adjust the balances in Account 100.1, and the related primary plant Account 231, "Station apparatus," to reflect the original cost of the surviving telephone instruments acquired by
54 New York from A. T. & T. on December 31, 1927; by debits to those accounts in the amount of the difference between such original cost and the surviving amounts recorded in such Accounts; and (d) to adjust the balance in Account 171, to reflect appropriately the elimination of the inter-company profit or write-up of $4,166,510.57 resulting from the accounting performed by New York at the time of and during the period since such acquisitions, with respect to and as a result of such acquisitions, by credits to that account equal to the difference between the amounts debited to Account 100.1 and Account 413, and the amounts credited to Account 100.4;

(3) Respondent has violated the Commission's Accounting Rules and Regulations by making unauthorized entries in its accounts for the purpose of amortizing through charges and credits to its operating expense accounts amounts it has included in its Account 100.4; but under the circumstances, other than the entries required herein, no further action by the Commission with respect thereto is required, and the investigation with respect to such violation by respondent, its officers and directors, shall be terminated and dismissed;

(4). All charges which respondent has made to its operating expense accounts for the purpose of, or in conjunction with, amortizing or otherwise disposing of all amounts included in its Account 100.4, other than those included therein with respect to the three toll property acquisitions from A. T. & T. in 1925, 1926, and 1928, shall continue to be suspended, and respondent shall cease and desist from making any such charges to its operating expense accounts, pending submission of proof by respondent of the propriety and reasonableness of such charges, and the specific direction, authorization, or approval of the Commission.

An appropriate Order will issue.

FEDERAL COMMUNICATIONS COMMISSION,
(Sgd.) T. J. SLOWIE,
T. J. Slowie, *Secretary*.

Adopted December 14, 1943.

55 Before the Federal Communications Commission, Washington, D. C.

Docket No. 6329—P-30

In the Matter of New York Telephone Company, Accounting

ORDER

At a session of the Federal Communications Commission held at its offices in Washington, D. C., on the 14th day of December 1943;

The Commission, having under consideration the record of the proceedings herein, including its Proposed Report herein adopted June 22, 1943, the exceptions and arguments with respect thereto; and having this day adopted its Report herein;

It is ordered, That the Report of the Commission adopted this day in this proceeding be, and it is hereby made a part hereof by reference;

It is further ordered, That:

(1) The New York Telephone Company shall charge (debit) the amount of $4,166,510.57 to its Account 413, "Miscellaneous Debits to Surplus";

(2) The New York Telephone Company shall, concurrently with such charge to Account 413, make entries (a) to eliminate, by appropriate entries to its Account 100.4, "Telephone Plant Acquisition Adjustment," the amounts presently included in that account, associated with the New York Telephone Company's acquisition from the American Telephone and Telegraph Company on November 1, 1925, September 1, 1926, and Decem-
56 ber 31, 1928; (b) to eliminate the Amounts presently included in Account 172, "Amortization Reserve," associated with such acquisitions, with contra entries to Account 171, "Depreciation Reserve"; (c) to adjust the balances in Account 100.1, "Telephone Plant in Service," and the related primary plant Account 231, "Station Apparatus," to reflect the original cost of the surviving telephone instruments acquired by the New York Telephone Company from the American Telephone and Telegraph Company on December 31, 1927, by debits to those accounts in the amount of the difference between such original cost and the surviving amounts recorded in such accounts; and (d) to adjust the balance in Account 171, to reflect appropriately the elimination of the inter-company profit or write-up of $4,166,510.57 resulting from the accounting performed by the New York Telephone Company at the time of and during the period since such acqui-

sition, with respect to and as a result of such acquisitions, by credits to that account equal to the difference between the amounts debited to Account 100.1 and Account 413, and the amounts credited to Account 100.4;

(3) The New York Telephone Company shall correct its books and records as of December 31, 1941, by placing thereon the following entries:

Entry No. 1	Debit	Credit
100.1 Telephone Plant in Service (Account 231, Station Apparatus)	$194,886.97	
100.4 Telephone Plant Acquisition Adjustment		$481,439.60
171 Depreciation Reserve		3,879,957.94
413 Miscellaneous Debits to Surplus	4,166,510.57	

This entry made in accordance with the order of the Federal Communications Commission dated December 14, 1943, in Docket No. 6329.

Entry No. 2	Debit	Credit
171 Depreciation Reserve		$333,559.21
172 Amortization Reserve	$333,550.21	

This entry made in accordance with the order of the Federal Communications Commission dated December 14, 1943, in Docket No. 6329.

57 (4) The New York Telephone Company shall make any necessary entries to adjust entries reflecting transactions subsequent to December 31, 1941, and to adjust between Account 231, "Station apparatus," and Account 122, "Material and Supplies," as may be required to be consistent with the entries required by the above provisions of this order.

(5) All charges which the New York Telephone Company has made to its operating expense accounts for the purpose of, or in conjunction with, amortizing or otherwise disposing of all amounts included in its Account 100.4 other than those included therein with respect to the toll property acquisitions dated November 1, 1925, September 1, 1926, and December 31, 1928, shall continue to be suspended, and respondent shall cease and desist from making any such charges to its operating expense accounts, pending submission of proof by respondent of the propriety and reasonableness of such charges, and the specific direction, authorization, or approval of the Commission;

It is further ordered, That the investigation instituted by the Commission's order of June 16, 1942, herein, to determine whether respondent or any of its officers or directors has violated certain of the Commission's accounting rules and regulations be, and it is hereby terminated and dismissed;

It is further ordered, That the New York Telephone Company shall within 60 days from the service of this order submit verified proof that the journal entries required herein have been made.

It is further ordered, That the New York Telephone Company shall within 40 days from the service of this order notify this Commission in writing whether this order and all of its terms and requirements are accepted and will be obeyed.

By the Commission.

(Sgd.) T. J. Slowie,
T. J. Slowie, *Secretary.*

58 *Exhibit B to complaint*

District Court of the United States, Southern District of New York

In Equity No. 81-366

American Telephone and Telegraph Company, et al., plaintiffs

v.

The United States of America et al., defendants

Extracts From Findings of Fact of the District Court, Filed March 24, 1936

III

Telephone Division Order No. 7-C requires plaintiffs to include in the telephone plant accounts the "original cost" of their telephone plant, and provides that the difference between said original cost and cost to the accounting company of property acquired from another public utility shall be recorded on their books in other specified investment accounts.

IV

Plaintiffs have heretofore performed accounting with respect to property acquired from other public utilities which resulted in the inclusion in their telephone plant accounts of amounts representing various costs, such as current cost new, actual cost to plaintiffs, structural value, or cost to the predecessor company (by merger of book accounts). The Uniform System of Accounts prescribed by Telephone Division Order No. 7-C requires that in accounting for property acquired from another public utility, and in all other instances, plaintiffs' telephone plant accounts shall be stated on a uniform basis, that being "original cost," as therein defined.

59 V

Telephone Division Order No. 7-C does not require that the recorded cost or investment of the plaintiffs in property theretofore acquired by them from another public utility be obliterated or eliminated from their investment accounts, but merely requires plaintiffs to segregate the element of recorded cost or investment into the following investment accounts:

100.1 Telephone plant in service.
100.2 Telephone plant under construction.
100.3 Telephone property held for future telephone use.
100.4 Telephone plant acquisition adjustment.

VI

Telephone Division Order No. 7-C further requires plaintiffs to include in their investment accounts the amount which they actually pay for property acquired on and after January 1, 1936, from other public utilities.

VII

Telephone Division Order No. 7-C requires plaintiffs to segregate in an account numbered 100.4 and entitled "Telephone plant acquisition adjustment," the difference between (a) the amount of money which they actually paid for telephone plant acquired and (b) the original cost of such plant less the amounts of reserve requirements for depreciation and amortization of the property acquired and amounts of contributions to the predecessor company or companies for the construction and acquisition of such property.

60 VIII

The plaintiffs are not prevented by Telephone Division Order No. 7-C from recovering amounts included in Account 100.4 in view of the alternative provisions of paragraph (C) of the text of said Account 100.4, which make provision for the amortization or other appropriate disposition of amounts included in Account 100.4. The Commission has made no direction with respect to the disposition of any such amounts.

IX

Telephone Division Order No. 7-C requires that plaintiffs' accounts shall be kept on a basis which will reflect the facts with

respect to their transactions and which will show their actual condition for the information of all persons interested therein, except with respect to contributions to predecessor utilities and depreciation of property held for future telephone use, and said order is capable of practical application except with respect to contributions to predecessor utilities.

X

Telephone Division Order No. 7–C does not prevent plaintiffs from recording in their expense accounts the expense of depreciation which they actually incur, except that said order does not provide for depreciation of the classes of depreciable property, the original cost of which is includible in Account 100.3, "Property held for future telephone use."

XI

Telephone Division Order No. 7–C does not require plaintiffs to write off any portion of their actual investment where
61 they have paid a price in excess of original cost, but merely requires a segregation of this actual cost into certain investment accounts, all of which will appear in the balance-sheet statements of plaintiffs; and no writing off is required by the provisions of Order No. 7–C when plaintiffs purchase property in the future, but only a segregation of such cost is required.

XII

Telephone Division Order No. 7–C does not require plaintiffs to make radical or retroactive changes in their completed accounts. In this respect said order merely requires the reclassification of balances as of its effective date in certain balance-sheet accounts.

XIII

Telephone Division Order No. 7–C does not require that amounts recorded in Account 100.4 be disposed of, written off, or amortized by plaintiffs. The form of the accounting to be performed is dependent upon the development of facts in connection with each individual acquisition. Said order merely provides for alternative modes of disposition adaptable to the facts of individual acquisitions.

62 *Exhibit C to complaint*

In the Supreme Court of the United States

October Term, 1936—No. 74

American Telephone and Telegraph Co., et al., appellants

v.

The United States of America, Federal Communications Commission, and National Association of Railroad and Utilities Commissioners

On Appeal From the District Court of the United States for the Southern District of New York

Supplemental Memorandum by the United States and the Federal Communications Commission

The Federal Communications Commission construes the provisions of Telephone Division Order No. 7–C, issued June 19, 1935, pertaining to account 100.4, as follows:

(1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.

63 (2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 186) or account 675 (R. 205).

The Commission believes that the foregoing construction of its order is that which it presented to the District Court through the affidavits of its witnesses.

Respectfully submitted.

Stanley Reed,
Solicitor General,
John Dickinson,
Assistant Attorney General,
Hampson Gary,
General Counsel,
Federal Communications Commission.

November —, 1936.

64 *Exhibit D to complaint*

60940

Before the Federal Communications Commission, Washington, D. C.

Docket No. 6329

IN THE MATTER OF NEW YORK TELEPHONE COMPANY ACCOUNTING

ORDER

At a session of the Federal Communications Commission held at its offices in Washington, D. C., on the 16th day of June 1942;

It appearing, That on November 1, 1925, September 1, 1926, and December 31, 1928, New York Telephone Company acquired certain telephone property from the Long Lines Department of American Telephone and Telegraph Company, its parent company; and that the amounts paid to American Telephone and Telegraph Company by New York Telephone Company for such property were $1,659,551.91 in excess of the book cost, as retired, less the related depreciation and amortization reserves, as reflected on the books of the Long Lines Department of American Telephone and Telegraph Company;

It further appearing, That on December 31, 1927, the New York Telephone Company acquired certain telephone instruments (receivers, transmitters, and induction coils) from American Telephone and Telegraph Company; and that the
65 amount paid to American Telephone and Telegraph Company by New York Telephone Company for such instruments was $2,506,958.66 in excess of the book cost less the related depreciation reserve, as reflected on the books of American Telephone and Telegraph Company; and

It further appearing, That as a result of the accounting performed by New York Telephone Company at the time of and since the respective dates of the acquisitions of telephone property, referred to above, an insufficient amount is included in its Account 100.4, "Telephone plant acquisition adjustment;" and that since the effective date, January 1, 1937, of the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies, New York Telephone Company has made, and is continuing to make, charges to operating expense accounts for the purpose of amortizing or otherwise disposing of amounts included in its Account 100.4, without prior direction, authorization, or approval by this Commission;

It is ordered, That an investigation be, and the same is hereby, instituted into the accounting performed and the accounts, records, and memoranda kept by New York Telephone Company at the time of and during the period since its several acquisitions of telephone property, with respect to and as a result of such acquisitions;

It is further ordered, That New York Telephone Company be, and it is hereby, made respondent to this proceeding; and that said respondent shall show cause, under oath, why the total amount of $4,166,510.57, representing amounts paid to American Telephone and Telegraph Company by the respondent for telephone property acquired from American Telephone and Telegraph Company by the respondent for telephone property acquired from American Telephone and Telegraph Company on November 1, 1925, September 1, 1926, December 31, 1927, and December 31, 1928, in excess of book cost less the related depreciation and amortization reserves, as reflected on the books of American Telephone and Telegraph Company and its Long Lines Department,
66 should not be charged to New York Telephone Company's Account 413, "Miscellaneous debits to surplus," with concurrent entries to such accounts as may be appropriate in the light of the accounting performed at the time of and since the respective dates of the acquisitions of such telephone property;

It is further ordered, That all charges to operating expense accounts which have been made by the respondent on and after January 1, 1942, for the purpose of, or in conjunction with, amortizing or otherwise disposing of amounts included in its Account 100.4 be, and they are hereby, suspended pending submission of proof by the respondent of the propriety and reasonableness of such charges; and that the respondent shall cease and desist from making any such charges to operating expense accounts, pending submission of such proof, unless otherwise specifically directed by the Commission;

It is further ordered, That an investigation be, and the same is hereby, instituted to determine whether the respondent company or any of its officers and directors have violated the provisions of Account 100.4, Subsection (C) (Section 31.100.4, Rules and Regulations), and of Account 614 (Section 31.614, Rules and Regulations), of the Commission's Uniform System of Accounts for Class A and B Telephone Companies; Commission Order No. 60, adopted July 12, 1939; and Section 220 (g) of the Communications Act of 1934;

It is further ordered, That a hearing on the above matters be held in the office of the Public Service Commission of New York, State Office Building, 80 Centre Street, New York, New York, beginning at 10:00 a. m., on the 30th day of July, 1942, and that

on or before fifteen days from the date of service of this order the respondent and each of its officers and directors shall file with the Commission its and their respective verified answers to this order;

It is further ordered, That the hearing provided for by this order shall be conducted jointly with any hearings
67 involving similar matters which may be ordered for the same time and place by the Public Service Commission of New York and the Connecticut Public Utilities Commission; and that copies of this order shall be served upon the respondent and each of its officers and directors, the Public Service Commission of New York, the Connecticut Public Utilities Commission, the Massachusetts Department of Public Utilities, the Vermont Public Service Commission, the Pennsylvania Public Utility Commission, the New Jersey Board of Public Utility Commissioners, and the National Association of Railroad and Utilities Commissioners.

By the Commission.

(Sgd.) T. J. Slowie,
T. J. SLOWIE,
Secretary.

68 *Exhibit E to complainant*

Before the Federal Communications Commission

Docket No. 6329

IN THE MATTER OF NEW YORK TELEPHONE COMPANY, ACCOUNTING

The New York Telephone Company, respondent herein, for its answer to the order of the Federal Communications Commission dated June 16, 1942, upon information and belief:

First. Admits each of the allegations of the first paragraph of the order except that it does not admit that the related depreciation and amortization reserves as reflected on the books of the Long Lines Department of the American Telephone and Telegraph Company therein referred to were as stated in said paragraph and denies that any separate reserve was set up on the books of the American Telephone and Telegraph Company for the particular property in question or for the class of property to which it belonged, but admits that the figures stated in said paragraph are correct upon the basis of an estimated allocation of the book reserves of the American Telephone and Telegraph Company made by that Company. In connection with the foregoing admissions and denials the respondent alleges and explains that the reserves referred to in said paragraph are irrelevant insofar as the trans-

action referred to may be in anywise subject to the present system of accounts, as that system deals only with reserve requirement and not with vendor's book reserves.

69 Second. Admits each of the allegations contained in the second paragraph of the said order except that it does not admit that the related depreciation and amortization reserves as reflected on the books of the American Telephone and Telegraph Company therein referred to, were as stated in said paragraph but admits that the said American Telephone and Telegraph Company did maintain a reserve for instruments generally and that the figures set forth in paragraph 2 are correct upon the basis of an estimated allocation of the book reserves of American Telephone and Telegraph Company made by that Company. Furthermore, in connection with the foregoing admissions and denials the respondent alleges that the reserves referred to in said paragraph are irrelevant in so far as the transaction referred to may be in anywise subject to the present system of accounts as that system deals only with reserve requirement and not with vendor's book reserves.

Third. Denies each of the allegations contained in the third paragraph of said order.

Fourth. In connection with and in explanation of all of the foregoing admissions and denials, respondent alleges as follows:

(a) The amounts paid to the Long Lines Department of the American Telephone and Telegraph Company for the property purchased from it on November 1, 1925, September 1, 1926, and December 31, 1928, and referred to in the first paragraph of the said order of this Commission were not in excess of the fair and reasonable value of said property at the respective times of purchase.

(b) That the reason for the said transfer was as follows:

The American Telephone and Telegraph Company withdrew from intrastate toll business within the State of New York

70 and respondent withdrew from certain interstate toll business. Because of the foregoing, the respondent needed the plant in question and the American Telephone and Telegraph Company no longer required the same.

(c) The amounts paid to the Long Lines Department of American Telephone and Telegraph Company were not in excess of the fair value of said physical property or of the reproduction cost new thereof less actual depreciation.

(d) At the times of said purchases the respondent was subject to the authority and jurisdiction of the Interstate Commerce Commission and said transactions were recorded on the books of account of respondent in accordance with the accounting rules and practices prescribed by it.

(e) The prices paid by respondent for said properties purchased in 1925 and 1926 were attacked by the Public Service Commission of the State of New York and The City of New York in the rate case brought by respondent against the New York Public Service Commission in April 1924, in the United States District Court, Southern District of New York (in Equity 29–126), the trial of which case was not concluded until October 1928, were litigated therein, and the said Court sustained the reasonableness of said transaction and included said property in respondent's rate base at the price paid for it, and respondent submits that it should not be required to litigate again the matter of the value of said property.

(f) Approximately half of the said property purchased in 1925, 1926, and 1928 had been retired from service prior to January 1, 1937, the effective date of the present system of accounts. The entire price paid for that which remained in service in January 1937 did not constitute more than four-tenths of one per cent. of respondent's plant account. The price of that now remaining in service is still less.

(g) Respondent by fair and reasonable methods determined what portions of the property purchased from the American
71 Telephone and Telegraph Company in 1925, 1926, and 1928
and referred to in the said order of this Commission of June 16, 1942, were still in service in January 1937, determined the "original cost" thereof, retained only that portion of its actual or book cost in Account 100.1, and transferred the balance by appropriate entries from Account 100.1 to Account 100.4. This Commission was informed of the amounts so transferred and the method followed in arriving at the same, and no exception was taken thereto by it for more than four years.

(h) After setting up said Account 100.4 respondent proceeded to amortize amounts included therein, including the amounts referred to in (g) above, concerning which this Commission was informed by the American Telephone and Telegraph Company and such amortization respondent then understood met with the approval of this Commission.

(i) As appears from (a), (b), (c), (d), and (e) above, the property above discussed was worth as much as or more than the price paid for it, was useful and necessary to respondent and represents an investment which respondent "made in assets of continuing value," and an investment "definitely attributable to depreciable telephone plant," within the meaning of those words as used in stipulation filed by this Commission with the United States Supreme Court in November 1936 in case of American Telephone and Telegraph Company v. Federal Communications Commission.

(j) With respect to the allegation in the third paragraph of the order that an insufficient amount is included in respondent's Account 100.4, respondent alleges that under the Uniform System of Accounts and binding constructions thereof by this Commission, no figure for reserve requirement was, or should have been, entered in the depreciation reserve with a corresponding entry in Account 100.4.

(k) With respect to the purchase of instruments in December 1927, the price paid by the respondet to the American Telephone and Telegraph Company for said instruments was a fair
72 and reasonabie one and the amount set up in the plant accounts of this respondent was not in excess of the value of the property acquired and the manner in which it was accounted for was in accordance with the system of accounts of the Interstate Commerce Commission in force and effect at the time when the transaction took place.

(l) The price paid by respondent for said instruments was attacked by the Public Service Commission of the State of New York and The City of New York in the case of New York Telephone Company against the Public Service Commission of the State of New York (in Equity 29–126), above referred to, was litigated therein, and the court sustained the reasonableness of said transaction and included said instruments in respondent's rate base at the price paid for them, and the respondent submits that it ought not to be required to litigate again the matter of the value of said instruments.

Fifth. Answering the order to show cause why an amount equal to $4,166,510.57 should not be charged to Account 413, Miscellaneous Debits to Surplus with concurrent entries to such accounts as may be appropriate in the light of the accounting performed at the time of and since the respective dates of the acquisitions of the telephone property referred to in paragraphs 1 and 2 of the order, respondent alleges as follows:

1. As above stated, the transactions were fair and proper transactions at the time when made.

2. They were properly recorded on the books of the respondent according to the system of accounts which was in effect at the time of such transactions.

3. With respect to the purchase of the instruments, nothing in the accounting provisions of the Uniform System of Accounts prescribed by this Commission requires any change in the accounts of the respondent.

4. With respect to the purchases referred to in the first
73 paragraph of the order of this Commission, to the extent that said System of Accounts has any application thereto, its provisions have been complied with, appropriate amounts have

been entered in Account 100.4 and the entries to operating expense accounts for the purpose of amortizing amounts so included in Account 100.4 have been made in accordance with a plan approved by the Commission.

5. No other entries, and specifically no entry to Account 413 Miscellaneous Debits to Surplus in the amount of $4,166,510.57, are required or appropriate under the Commission's system of accounts and binding administrative constructions with respect thereto.

Wherefore respondent respectfully prays that the order herein dated June 16, 1942, be vacated and set aside and that the proceeding commenced thereby be dismissed.

New York Telephone Company,
By (Sgd.) Frank A. Fritz,
Assistant General Attorney,
140 West Street, New York, N. Y.

Dated: New York, N. Y., July 3, 1942.

74 [*Duly sworn to by Benjamin F. Young; jurat omitted in printing.*]

75 *Exhibit F to complaint*

Before the Federal Communications Commission

Docket No. 6329—P-30

In the Matter of New York Telephone Company, Accounting

Petition for Modification of Order Dated December 14, 1943

Now comes New York Telephone Company, the respondent herein, and respectfully prays that the Commission modify its order herein dated December 14, 1943 (hereinafter referred to as "the Order"), in the respects and for the reasons hereinafter set forth:

1. Respondent intends to institute a proceeding in the District Court of the United States for the Southern District of New York, pursuant to Section 402 (a) of the Communications Act of 1934 and the Act of October 22, 1913, Ch. 32, 38 Stat. 219, 220, to enjoin, set aside, annul and suspend the Order, on the ground that the Order exceeds the powers conferred by the Communications Act of 1934, and for this and other reasons is illegal and void. Respondent intends to institute such proceedings promptly and in any event before the expiration of the 60-day period set forth in the fourth ordering paragraph of the Order.

2. Subparagraphs (1) and (2) of the second ordering paragraph of the Order require respondent to make entries affecting Accounts 413, 100.1, 100.4, 231, 171, and 172. Subparagraph (3) of the second

ordering paragraph of the Order requires respondent to make entries affecting Accounts 100.1, 100.4, 171, 172, and 413, as of December 31, 1941. Subparagraph (4) of the second order-
76 ing paragraph of the Order requires respondent to make any necessary entries to adjust entries reflecting transactions subsequent to December 31, 1941, and to adjust between Accounts 231 and 122 as may be required to be consistent with the other entries required by the Order. The making of the entries required by the Order would also affect respondent's current charges for depreciation and retirement so far as concerns the instruments acquired from American Telephone & Telegraph Company which are recorded in Account 231.

3. Respondent is under the necessity of making a large number of financial reports to this Commission, to the Public Service Commissions of New York and Connecticut, to various tax authorities, Federal and state, to the Securities and Exchange Commission, to the New York Stock Exchange, to the holders of its Series C 3% Bonds, and to investors generally. Certain of these reports are issued monthly, certain of them are issued quarterly and certain of them are issued annually.

4. Respondent considers that it would be seriously detrimental to its interests to be required, while proceedings for the review of the Order are pending, to show in the said reports the reduction in surplus and the increase in its already adequate depreciation reserve which are prescribed by the Order and which respondent does not regard as consistent with the facts. Respondent further considers that it would be seriously detrimental to its interests to be required, prior to ultimate determination as to the validity of the Order, to make the entries set forth in paragraph 2 of this petition, all of which entries will be reversed if the Order is determined to be invalid.

5. Respondent therefore requests that the Commission modify the fourth ordering paragraph of the Order so as to extend the time within which respondent is required to submit verified proof of the making of the journal entries required by subparagraphs (1), (2), (3), and (4) of the second ordering paragraph of the Order, to a date 30 days from the final determination of a proceeding to be instituted by the respondent to enjoin, set aside,
77 annul and suspend the Order as set forth in paragraph 1 hereof. In the event of such modification of the Order, respondent would propose to charge to its Account 415, "Miscellaneous Reservations of Surplus," and concurrently credit to its Account 180, "Surplus Reserved," the amount of $4,166,510.57, referred to in the Order, with appropriate notation, and to retain

the said sum in Account 180 pending the final determination of the proceeding referred to in paragraph 1 of this petition, at which time appropriate entries in accordance with such final determination would be made.

6. The modification of the Order proposed in paragraph 5 of this petition would reserve the amount of surplus necessary to enable respondent to comply with the Order if the Order is upheld and would avoid the needless injury and damage to the respondent that would otherwise ensue.

Wherefore, respondent respectfully prays that the Commission enter an order herein modifying the fourth ordering paragraph of the Order so as to extend the time within which respondent is required to submit verified proof of the making of the journal entries required by subparagraphs (1), (2), (3), and (4) of the second ordering paragraph of the Order, to a date 30 days from the final determination of a proceeding to be promptly instituted by the respondent to enjoin, set aside, annul and suspend the Order, upon condition that respondent submit verified proof within 10 days from the making of such amendatory order that it has made entries in its Accounts 415 and 180, as set forth in paragraph 5 of this petition, and that respondent retain in Account 180 the amount transferred by such entries pending the final determination of such proceeding; and for such other, further and different relief as may be just and equitable.

New York Telephone Company,
By Ralph W. Brown,
Vice-President and General Counsel,
Attorney for Respondent.

Dated, New York City, January 15, 1944.

78 *Exhibit G to complaint*

Before the Federal Communications Commission, Washington 25, D. C.

Docket No. 6329—P-30

In the Matter of New York Telephone Company, Accounting

Order

At a session of the Federal Communications Commission held at its office in Washington, D. C., on the 25th day of January 1944:

The Commission, having under consideration its Report and Order of December 14, 1943 herein (P-30), and having also under

consideration a petition filed on January 17, 1944 by the New York Telephone Company for modification of the above Order of the Commission, so as to extend the time for compliance with the Order pending determination of a court proceeding to be promptly instituted by the Telephone Company to enjoin the Order, upon condition that the Company retain the amount of $4,166,510.57 in its account 180, "Surplus reserved," pending the final determination of the court proceeding;

It is ordered, That to the extent that the Commission's Order of December 14, 1943 herein requires that the New York Telephone Company shall submit within 60 days from the service of that Order, verified proof that the journal entries required there-
79 in have been made, such Order is hereby modified to the effect that such verified proof shall be filed at a later date to be specified by subsequent Order of the Commission, having regard to the course of the court proceeding which the New York Telephone Company intends promptly to institute with respect to such Order of the Commission; provided, however, that the New York Telephone Company shall comply with the following conditions: The New York Telephone Company shall charge to its account 415, "Miscellaneous reservations of surplus," and concurrently credit to its account 180, "Surplus reserved," the amount of $4,166,510.57, with appropriate notations in all published balance sheets; the New York Telephone Company shall submit verified proof within ten days from the date of this Order that such entries in its accounts 415 and 180 have been made; and the New York Telephone Company shall, until further order of the Commission, retain in its account 180 the amount of $4,166,510.57 transferred to that account by such entries.

By the Commission.

(SGD.) T. J. SLOWIE,
T. J. Slowie, *Secretary.*

80 In United States District Court

[Title omitted.]

Order convening three-judge court

The plaintiff herein having filed a petition verified the 9th day of February, 1944 in which it prays that this Court enter a judgment permanently enjoining, setting aside, annulling, and suspending a certain order of the Federal Communications Commission, in the proceeding which is said Commission's Docket

No. 6329, and said proceeding having been brought under the provisions of the Urgent Deficiencies Appropriations Act (38 Stat. 219, 220; 28 U. S. C. §§ 41 (28), 43–48 inclusive) which sections provide for the appointment of a special Court, consisting of three Judges, of whom at least one shall be a Circuit Judge, in all actions to set aside and annul orders of the Interstate Commerce Commission, and under the provisions of the Communications Act of 1934 (48 Stat. 1064, 1093; 47 U. S. C. § 402 (a)) which provides that the provisions relating to the enforcing or setting aside of the orders of the Interstate Commerce Commission are made applicable to suits to enforce, enjoin, set aside, annul, or suspend any order of the Federal Communications Commission, with certain exceptions not here applicable.

The undersigned hereby calls the Honorable Thomas W. Swan, United States Circuit Judge for the Second Circuit, and the Honorable John W. Clancy, United States District Judge for the Southern District of New York, to the assistance of the undersigned, to hear the said suit and any proceedings in connection therewith.

Dated New York, N. Y., March 17, 1944.

JOHN BRIGHT, *U. S. D. J.*

82 In United States District Court

[Title omitted.]

Notice of motion for summary judgment

SIR: Please take notice that on the complaint herein, together with the exhibits thereto annexed and on the annexed affidavit of Charles R. Denny, sworn to the 17th day of March 1944, together with the certified record of proceedings had in Federal Communications Commission Docket No. 6329 and upon all the other papers and proceedings heretofore filed and had herein, the undersigned will move the Honorable Thomas W. Swan, the Honorable John Bright, and the Honorable John W. Clancy, constituting a special court appointed pursuant to a certain order dated March 17, 1944, on the 1st day of June 1944, in Room 506 of the United States Court House, Foley Square, Borough of Manhattan, City and State of New York, at 2:30 o'clock in the afternoon of said day, or at such time and place as the aforesaid court may designate, for an order directing that summary judgment be entered in favor of the defendants on the ground that the complaint and exhibits annexed thereto, the annexed affidavit and the record of proceedings in said

Commission's Docket No. 6329 show that there is no genuine issue as to any material fact and that the defendants are entitled to a judgment as a matter of law.

Dated New York, N. Y. March 28, 1944.

Yours, etc.

JAMES B. MCNALLY,

United States Attorney for the Southern District of New York, Attorney for United States of America. Office & P. O. Address: United States Court House, Foley Square, Borough of Manhattan, City of New York.

CHARLES R. DENNY,

General Counsel, Federal Communications Commission, Attorney for Federal Communications Commission. Office & P. O. Address: New Post Office Bldg., Washington, D. C.

To: HENRY J. FRIENDLY, Esq.

31 Nassau Street, Borough of Manhattan, City of New York. Attorney for Petitioner.

83 In United States District Court

[Title omitted.]

Affidavit of Charles R. Denny

DISTRICT OF COLUMBIA, *ss:*

Charles R. Denny, being duly sworn, says:

1. He is General Counsel of the Federal Communications Commission, and as such is familiar with the Commission's proceedings in Docket 6329, and that the proceedings include the following:

(a) On June 16, 1942, the Commission issued an order reciting that on November 1, 1925, September 1, 1926, and December 31, 1928, New York Telephone Company, acquired certain telephone property from its parent, American Telephone and Telegraph Company, for which it paid an amount $1,659,551.91 in excess of the book cost, as retired, less the related depreciation and amortization reserves as reflected on the books of American Telephone and Telegraph Company; and that on December 31, 1927, New York Telephone Company acquired certain telephone instruments from American Telephone and Telegraph Company for which it paid an amount $2,506,958.66 in excess of the book cost less the related depreciation reserve as reflected on the books of American Telephone and Telegraph Company. The order further recited that as a result of the ac-

counting performed by New York Telephone Company at the time of and since the respective dates of the above acquisitions, an insufficient amount is included in its Account 100.4, "Telephone plant acquisition adjustment"; and that since the effective date, January 1, 1937, of the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies, New York Telephone Company has made, and is continuing to make, charges to operating expense accounts for the purpose of amortizing or otherwise disposing of amounts included in its Account 100.4, without prior direction, authorization, or approval by the Commission.

(b) The order of June 16, 1942, directed that a general investigation be instituted into the accounting performed and the accounts, records, and memoranda kept by New York Telephone Company at the time of and during the period since all of its several acquisitions of telephone property, with respect to and as a result of such acquisitions. New York Telephone Company was made a respondent and it was required to show cause why the amount of $4,166,510.57 should not be charged to respondent's Account 413, "Miscellaneous debits to surplus," with concurrent entries to such accounts as may be appropriate in the light of the accounting performed at the time of and since the respective dates of the four acquisitions with which such amount was associated.

(c) The order of June 16, 1942, also suspended all charges to operating expense accounts made by New York on and after January 1, 1942, for the purpose of, or in conjunction with, amortizing or otherwise disposing of amounts included in its Account 100.4 "Telephone plant acquisition adjustment,"
84 pending submission of proof by respondent of the propriety and reasonableness of such charges; and ordered respondent to cease and desist from making any such charges pending submission of such proof.

(d) A hearing was ordered for July 30, 1942, and it was provided that the hearing should be conducted jointly with any hearings involving similar matters which might be ordered for the same time and place by the Public Service Commission of New York and the Connecticut Public Utilities Commisison. It was also ordered that the order should be served upon respondent and each of its officers and directors, the Public Service Commission of New York, the Connecticut Public Utilities Commission, the Massachusetts Department of Public Utilities, the Vermont Public Service Commission, the Pennsylvania Public Utility Commission, the New Jersey Board of Public Utility Commissioners, and the National Association of Railroad and Utilities Commissioners.

(e) On January 25, 1938, the New York State Public Service Commission had instituted its Case No. 9436 by an order of investigation into the books, records, and accounts of New York Telephone Company and as to its entries reflecting the acquisition of property acquired from other telephone companies. Hearings before that Commission had been held in February 1938, and October 1939, and the matter was set down for further hearing at the same time and place as the hearing ordered by the Federal Communications Commission in Docket 6329.

(f) Joint hearings were held before Commissioners Walker and Wakefield of the Federal Communications Commission, and Commissioners Maltbie and Van Nasee of the New York Public Service Commission. Hearings were begun on July 30, 1942. Further hearings were held on July 31, September 16, 17, 18, 30, October 14, 15, 16, 28, 29, 30, November 25, December 10 and 11, 1942. New York Telephone Company participated and presented evidence in these hearings. Evidence was also submitted by members of the staff of both Commissions and witnesses called on behalf of both Commissions.

(g) On January 19, 1943, New York Telephone Company filed its Proposed Findings of Fact and Conclusions, and a supporting brief.

(h) On June 22, 1943, the Commission issued its Proposed Report in which it concluded that the amount of $4,166,510.57 should be charged to Account 413, "Miscellaneous debits to surplus," with concurrent entries to appropriate accounts, specified in the Proposed Report.

(i) On July 16, 1943, New York Telephone Company filed exceptions to the Commission's Proposed Report, together with a supporting brief, and requested oral argument before the Commission. Oral argument was held before the Commission en banc on September 22, 1943.

(j) On December 14, 1943, the Commission issued its final Report and Order. The Commission directed that:

(1) The New York Telephone Company shall charge (debit) the amount of $4,166,510.57 to its Account 413, "Miscellaneous Debits to Surplus";

85 (2) The New York Telephone Company shall, concurrently with such charge to Account 413, make entries (a) to eliminate, by appropriate entries to its Account 100.4, "Telephone Plant Acquisition Adjustment," the amounts presently included in that account, associated with the New York Telephone Company's acquisition from the American Telephone and Telegraph Company on November 1, 1925, September 1, 1926, and December 31, 1928; (b) to eliminate the Amounts presently in-

cluded in Account 172, "Amortization Reserve," associated with such acquisitions, with contra entries to Account 171, "Depreciation Reserve"; (c) to adjust the balances in Account 100.1, "Telephone Plant in Service," and the related primary plant Account 231, "Station Apparatus," to reflect the original cost of the surviving telephone instruments acquired by the New York Telephone Company from the American Telephone and Telegraph Company on December 31, 1927, by debits to those accounts in the amount of the difference between such original cost and the surviving amounts recorded in such accounts; and (d) to adjust the balance in Account 171, to reflect appropriately the elimination of the intercompany profit or write-up of $4,166,510.57 resulting from the accounting performed by the New York Telephone Company at the time of and during the period since such acquisition, with respect to and as a result of such acquisitions, by credits to that account equal to the difference between the amounts debited to Account 100.1 and Account 413, and the amounts credited to Account 100.4;

(3) The New York Telephone Company shall correct its books and records as of December 31, 1941, by placing thereon the following entries:

Entry No. 1

		Debit	Credit
100.1	Telephone plant in service (account 231, station apparatus)	$194,886.97	
100.4	Telephone plant acquisition adjustment		$481,439.60
171	Depreciation reserve		3,879,957.94
413	Miscellaneous debits to surplus	4,166,510.57	

This entry made in accordance with the order of the Federal Communications Commission dated December 14, 1943, in Docket No. 6329.

Entry No. 2

		Debit	Credit
171	Depreciation reserve		$333,559.21
172	Amortization reserve	$333,559.21	

This entry made in accordance with the order of the Federal Communications Commission dated December 14, 1943, in Docket No. 6329.

(4) The New York Telephone Company shall make any necessary entries to adjust entries reflecting transactions subsequent to December 31, 1941, and to adjust between Account 231, "Station apparatus," and Account 122, "Material and Supplies," as may be required to be consistent with the entries required by the above provisions of this order.

86 (5) All charges which the New York Telephone Company has made to its operating expense accounts for the purpose of, or in conjunction with, amortizing or otherwise disposing of; all amounts included in its Account 100.4 other than those included therein with respect to the toll property acquisitions dated November 1, 1925, September 1, 1926, and December 31, 1928, shall continue to be suspended, and respondent shall cease and desist from making any such charges to its operating expense accounts, pending submission of proof by respondent of the propriety and reasonableness of such charges, and the specific direction, authorization, or approval of the Commission.

(k) The Order further provided that the New York Telephone Company should within 60 days submit verified proof that the journal entries required by the Order had been made, and that it should within 40 days notify the Commission in writing whether the order and all of its terms and requirements are accepted and will be obeyed.

(l) On December 14, 1943, the New York Public Service Commission also issued its Report and Order in its Case No. 9436. This Order is substantially the same as that of the Federal Communications Commission.

(m) On January 17, 1944, New York Telephone Company filed a Petition for Modification of Order, requesting an extension of time for compliance with the Commission's Order of December 14, 1943, until 30 days after final determination of a court proceeding to be instituted by New York Telephone Company to set aside, enjoin, annul, and suspend the order;

(n) On January 25, 1944, the Commission issued an order providing in part as follows:

"That to the extent that the Commission's Order of December 14, 1943, herein requires that the New York Telephone Company shall submit within 60 days from the service of that Order, verified proof that the journal entries required therein have been made, such Order is hereby modified to the effect that such verified proof shall be filed at a later date to be specified by subsequent Order of the Commission, having regard to the course of the court proceeding which the New York Telephone Company intends promptly to institute with respect to such Order of the Commission; provided, however, that the New York Telephone Company shall comply with the following conditions: The New York Telephone Company shall charge to its account 415, 'Miscellaneous reservations of surplus,' and concurrently credit to its account 180, 'Surplus reserved,' the amount of $4,166,510.57, with appropriate notations in all published balance sheets; the New York Telephone Company shall submit verified proof within ten days from the

date of this Order that such entries in its accounts 415 and 180 have been made; and the New York Telephone Company shall, until further order of the Commission retain in its account 180 the amount of $4,166,510.57 transferred to that account by such entries."

2. A certified copy of said proceedings before the Commission in Docket No. 6329 is filed herewith and incorporated herein by reference as Exhibit A.

3. The grounds urged by plaintiff in support of its contention that the order of the Commission is not supported by substantial evidence, is entirely at odds with fundamental principles of correct accounting, is beyond the statutory power and authority of the Commission, and is illegal and void, are as follows:

87 (a) The Order requires the correction of an alleged error in plaintiff's accounting, although no error was made and such accounting was in accordance with the requirements of the Uniform System of Accounts for Telephone Companies prescribed by the Interstate Commerce Commission, to which plaintiff was subject at the date when the transaction occurred;

(b) The Order requires accounting for property purchased from an affiliated company, at a date prior to the effective date of the Federal Communications Commission's Uniform System of Accounts for Telephone Companies, in a bona fide transaction and at a fair price, which is wholly different from the accounting for property purchased from a company not so affiliated, although no provision of the Uniform System of Accounts for Telephone Companies prescribed by the Interstate Commerce Commission which was in effect at the time of the transactions here in question, or of the later revision of said System, or of the Uniform System of Accounts for Telephone Companies prescribed by the Federal Communications Commission, makes any distinction between purchases from an affiliated company and purchases from a company not so affiliated;

(c) The Order prevents the plaintiff from showing in its accounts the facts as to the purchases of property made by it from the American Company as set forth in this complaint, and requires the plaintiff to account for the said purchase on a basis which will not reflect either the plaintiff's actual investment in the property acquired or the value thereof;

(d) The Order compels the plaintiff to rewrite its accounts as if a rule of substantive law required that a purchase of property from an affiliated telephone company must be at the net book cost of the selling company or that a purchase on any other basis must be disregarded as "fictitious," although no such rule of sub-

stantive law existed at the time of the transactions here in question, or now exits, and although the Commission has not been vested with power to establish any such rule of substantive law either prospectively or retroactively;

(e) The Order prescribes a rule of accounting to be made retroactively effective with respect to transactions executed prior to the effective date of the Commission's Uniform System of Accounts and of the Communications Act of 1934;

(f) The Order prescribes a rule of accounting to be made retroactively effective to a date when plaintiff's accounts were prescribed by the Interstate Commerce Commission, as the duly authorized agency of the Government, and the rule now sought to be made retroactively effective by the Commission is at variance with the accounting so prescribed by the Interstate Commerce Commission;

(g) The Order does not direct a reclassification of the balances existing in plaintiff's accounts as of January 1, 1937, the effective date of the Commission's Uniform System of Accounts for Telephone Companies, but requires that certain of said balances be written off to plaintiff's surplus account and that
88 a further write-off be made to plaintiff's surplus account in respect of property which had been removed from plaintiff's plant accounts and charged to its adequate depreciation reserve prior to the effective date of said Uniform System of Accounts;

(h) The Order requires accounting which is contrary to the Commission's Uniform System of Accounts for Telephone Companies as construed by this Court and in "the administrative construction binding upon the Commission in its future dealings with the companies" filed by these defendants in the Supreme Court of the United States, in the suit initiated in this Court entitled, "American Telephone and Telegraph Company, et al., plaintiffs, against United States of America and Federal Communications Commisison, defendants, In Equity No. 81–366," to which suit this plaintiff and these defendants were adverse parties;

(i) The Order requires plaintiff to increase its depreciation reserve, although the undisputed evidence showed that plaintiff's depreciation reserve was adequate;

(j) The Commission denied the plaintiff a fair hearing, particularly by depriving plaintiff of the opportunity to demonstrate fully that the amount paid by the plaintiff for the toll plant and instruments acquired by the plaintiff from the American Company did not exceed the value of the property so acquired; and

(k) For the reasons above set forth the Order deprives the plaintiff of its liberty and property without due process of law in

violation of the Fifth Amendment of the Constitution of the United States.

4. Affiant submits that Exhibit A is relevant on the above issues sought to be raised and that it shows that the order is within the Commission's authority conferred by the Communications Act; that it does not deprive plaintiff of its liberty and property without due process of law; that it is not arbitrary and capricious or contrary to law, but is proper and reasonable and is supported by substantial evidence; and that there is no genuine issue as to any material fact.

(Signed) Charles R. Denny.
CHARLES R. DENNY.

Subscribed to and sworn to before me this 17th day of March 1944.

HELEN A. MARSTON,
Notary Public.

89 Before the Federal Communications Commission,
Washington 25, D. C.

Docket No. 6329—P–30

IN THE MATTER OF NEW YORK TELEPHONE COMPANY, ACCOUNTING

Appearances: Edward L. Blackman, Esq., Ralph W. Brown, Esq., John H. Machan, Esq., and Frank A. Fritz, Esq., on behalf of New York Telephone Company; Harry Hertzoff, Esq., on behalf of the City of New York; R. J. McVeigh, Esq., and John T. Ryan, Esq., on behalf of the Public Service Commission of the State of New York; and Daryal A. Myse, Esq., on behalf of the Federal Communications Commission.

PROPOSED REPORT OF THE COMMISSION

1. This proceeding was initiated by order of the Commission on June 16, 1942. The Order instituted a general investigation into the accounting performed and the accounts, records, and memoranda kept by New York Telephone Company (hereinafter sometimes referred to as "New York"), at the time of and during the period since all of its several acquisitions of telephone property, with respect to and as a result of such acquisitions. The Order made New York respondent and required it to show cause why $4,166,510.57 should not be charged to respondent's Account 413, "Miscellaneous debits to surplus," with concurrent entries to such accounts as may be appropriate in the light of the accounting performed at the time of and since the respective

dates of the four acquisitions with which such amount was associated. The $4,166,510.57 was stated in the Order to represent amounts paid to American Telephone and Telegraph Company (hereinafter sometimes referred to as "A. T. & T.") by New York for telephone property acquired from A. T. & T. on November 1, 1925, September 1, 1926, December 31, 1927, and December 31, 1928, in excess of the book cost less the related depreciation and amortization reserves, as reflected on the books of A. T. & T. and its Long Lines Department.[1]

90 2. The Order of June 16, 1942, also suspended all charges to operating expense accounts made by New York on and after January 1, 1942, for the purpose of, or in conjunction with, amortizing or otherwise disposing of amounts included in its Account 100.4 "Telephone plant acquisition adjustment," pending submission of proof by respondent of the propriety and reasonableness of such charges; and ordered respondent to cease and desist from making any such charges pending submission of such proof. The Order further recited that as a result of the accounting performed by New York, at the time of and since the respective dates of the several acquisitions of telephone property specifically mentioned above, an insufficient amount is included in respondent's Account 100.4; and that since January 1, 1937, the effective date of the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies, New York made charges to operating expense accounts for the purpose of amortizing or otherwise disposing of amounts included in its Account 100.4 without prior direction, authorization, or approval by the Commission. An investigation was also ordered instituted to determine whether respondent or any of its officers and directors have violated the provisions of Account 100.4 (c),[2] Account 614,[3] Commission Order No. 60[4] or Section 220 (g) of the Communications Act of 1934. Respondent and each of its officers and directors were required to file verified answers. Appropriate notice was given to the State Commissions having jurisdiction with respect to New York and to the National Association of Railroad and Utilities Commissioners. Although a hearing is not a prerequisite to action by the Commission under Section 220 of the Act, a hearing was ordered, with provision for its conduct jointly with hearings involving similar matters before the New York and Connecticut State Commissions. Under Section 220 of the Act respondent has the statutory burden of justifying the ac-

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[1] The Long Lines Department of A. T. & T. operates a nation-wide system of interstate toll line circuits. A separate set of accounts is kept to reflect the separate operations of the Long Lines Department.

[2] Section 31.100 : 4 of the Commission's Rules and Regulations.

[3] Section 31.614 of the Commission's Rules and Regulations.

[4] Adopted July 12, 1939.

counting entries questioned by the Commission. (Cf. Re Additional Charges to Operating Expense Account 672 (Relief and Pensions), F. C. C. Docket No. 5188, decided December 2, 1942.)

3. On January 25, 1938, the New York State Public Service Commission had instituted its Case No. 9436 by an order of investigation into the books, records, and accounts of New York and as to its entries reflecting the acquisition of property acquired from other telephone companies. Hearings before that Commission had been held in February 1938, and October 1939, and the matter was set down for further hearing at the same time and place as the hearing ordered by this Commission in this proceeding. Joint hearings in both proceedings were held before Commissioners Walker and Wakefield, of this Commission, and Commissioners Maltbie and Van Namee of the New York State Public Service Commission, beginning July 30, 1942, and con-
91 tinuing intermittently to December 11, 1942. Proposed Findings of Fact and Conclusions and a Brief have been filed by New York.

4. Among the 22 or more acquisitions of telephone property prior to January 1, 1937, reported by New York and involved in this proceeding, only four are involved in the show cause provisions of the Commission's Order of June 16, 1942. These four were property acquisitions from A. T. & T. and the amounts of money involved are a major portion of the total amount involved in all of New York's telephone property acquisitions from predecessor telephone companies. A. T. & T. has at all times material to this proceeding controlled New York through its ownership of 100% of New York's Common stock. On November 1, 1925, September 1, 1926, and December 31, 1928, New York acquired portions of certain toll line property in the State of New York from the Long Lines Department of A. T. & T. and paid $5,973,441.47 therefor. Much of the acquired property was in the form of an additional interest in toll lines owned jointly by New York and A. T. & T. Portions of such acquired property had been originally constructed by New York and transferred to A. T. & T. at amounts equivalent to cost of construction. Those portions of the jointly owned property constructed by New York, and as to which ownership was retained by New York, are recorded on New York's books at the original cost to it. In accounting for the transactions the property acquired by New York was retired on the books of the Long Lines Department, at what A. T. & T. considered to be its book cost to A. T. & T. in the amount of $5,134,342.49; and an amount of $820,453.93 was charged (debited) to the depreciation and amortization reserve accounts of the Long Lines Department as the estimated alloca-

tion of the book reserves of the Long Lines Department related to that property. The amount paid by New York to A. T. & T. was, therefore, $1,659,551.91 in excess of the book cost less the related depreciation and amortization reserves, as reflected on the books of A. T. & T. On December 31, 1927, New York acquired certain telephone instruments from A. T. & T. The instruments acquired consisted of all of the principal operating parts of the telephone subscriber stations (receivers, transmitters and induction coils) in use at the time by New York. The amount paid by New York to A. T. & T. was $6,661,238.91. In accounting for this transaction A. T. & T. retired the instruments on its books at what it considered to be book cost to it, in an amount of $8,135,224.98; and an amount of $3,980,944.73 was charged (debited) to its depreciation reserve account for telephone instruments as the estimated allocation of such reserve related to those instruments. The amount paid by New York to A. T. & T. was, therefore, $2,506,958.66 in excess of the book cost less the related depreciation reserve, as reflected on the books of A. T. & T. The total of the two amounts of $1,659,551.91 and $2,506,958.66 equals $4,166,510.57 and this total amount was credited to A. T. & T.'s surplus accounts.[5] The Commis-
92 sion's Order of June 16, 1942, required New York to show cause why such amount should not be charged (debited) to New York's surplus account.

5. At the time of the respective acquisitions from A. T. & T., referred to above, New York recorded in its plant account as cost of telephone plant purchased the amounts paid to A. T. & T. No entries were made in New York's depreciation or amortization reserve accounts in connection with such acquisitions. Nor were special depreciation rates thereafter applied to the amounts recorded in New York's plant accounts with respect to such acquired property, but the current depreciation rates applicable to the respective classes of plant were applied to such amounts as long as such property remained in service. From time to time, as portions of such acquired property were retired from service, estimated amounts, based upon compiled averaging of retirement unit costs, were retired on New York's books by crediting such amounts to the plant accounts and debiting an equivalent amount to its depreciation and amortization reserves.

6. On January 1, 1937, the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies became

[5] The amount associated with the instrument transaction was credited to a special contingency surplus reserve account by A. T. & T.

effective[6] and its provisions are applicable to New York as a Class A Telephone Company. New York was thus required to reclassify the amounts recorded in its then existing accounts to conform with the provisions of such Uniform System of Accounts.[7] Under "Balance Sheet Accounts—Investments" the System provides that Account 100.1, "Telephone plant in service,"[8] shall include "the original cost of the company's property used in telephone service at the date of the balance sheet as classified under Accounts 201 to 277, inclusive"; and that Accounts 100.2 and 100.3[9] shall include the original cost of telephone plant under construction and property held for future telephone
93 use, respectively. The system further provides that Account 100.4,[10] "Telephone plant acquisition adjustment," shall include amounts "representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the properties acquired." "Original cost" as used in Accounts 100.1 to 100.4, inclusive, is defined in the System of Accounts by Section 31.01–3 (x) of the Rules and Regulations as "the actual money cost of (or current money value of any consideration other than money exchanged for) property at the time when it was first dedicated to the public use whether by the accounting company or by predecessors."[11]

7. In reclassifying its accounts as of January 1, 1937, New York first estimated the amounts attributable to the surviving toll line plant transferred to it in the 1925, 1926, and 1928 acquisitions from A. T. & T., which amounts had been originally included in its books on a so-called "structural value" basis. It then determined the difference between such amounts and what it assumed to be

[6] Part 31 of the Commission's Rules and Regulations. On June 19, 1935, the Telephone Division of the Commission (See 1 F. C. C. 3 and Order No. 20, 4 F. C. C. 41) adopted its Order No. 7–C which prescribed a Uniform System of Accounts for Telephone Companies having average annual operating revenues exceeding $50,000, effective January 1, 1936 (1 F. C. C. 45). The operation of Order No. 7–C was stayed pending final decision by the United States District Court for the Southern District of New York, in the case of American Telephone and Telegraph Company et al. v. The United States, in Equity No. 81–366. After the decree of the District Court was affirmed by the Supreme Court of the United States on December 7, 1936 (American Telephone and Telegraph Co. et al. v. United States, 299 U. S. 232), the Telephone Division adopted its Order No. 7–D amending its Order No. 7–C in certain respects and making the amended System of Accounts effective January 1, 1937 (3 F. C. C. 9).

[7] Section 31.91–2 (e) of the Commission's Rules and Regulations.

[8] Section 31.100 : 1 of the Commission's Rules and Regulations.

[9] Section 31.100 : 2 and 31.100 : 3 of the Commission's Rules and Regulations.

[10] Section 31.100 : 4 of the Commission's Rules and Regulations.

[11] See Section 213 (c) of the Communications Act of 1934.

the original cost of such surviving plant, as originally reflected on the books of the A. T. & T.,[12] and placed the amount of such difference in its Account 100.4. The net amount consisting of both debits and credits so reclassified in Account 100.4, with respect to such acquisitions, was $483,975.83. An attempt was made to determine the amounts of the requirements for depreciation and amortization of such surviving plant, necessary in addition to the future accruals over the estimated remaining life at the current depreciation rates of the respective plant classes, and an amount of $271,280.98 was transferred in 1937 from New York's Account 171, "Depreciation reserve,"[13] to its Account 172, "Amortization reserve."[14]

94 Neither this amount nor any other amount was subtracted from the assumed original cost of such surviving plant as the reserve requirements for depreciation and amortization of such plant in determining the amount included in Account 100.4. No amounts were credited to Account 171 in the process of reclassification. At no time has New York reclassified on an original cost basis the amounts in its accounts associated with its acquisition of the telephone instruments from A. T. & T. in 1927. No amounts were or are included in Account 100.4 as a result of that transaction. As of January 1, 1942, it was estimated by New York that approximately 9½ to 15% of the instruments acquired by New York in 1927 remained in service.

8. In 1938 New York began amortizing the amounts included in its Account 100.4 by charges and credits to its operating expense Account 614, "Amortization of telephone plant acquisition adjustment," with concurrent entries to its Account 172. From time to time, when portions of the acquired plant were retired, amounts in Account 100.4 were written out of that account with a concurrent entry to Account 172. These amortization charges to Account 614 from January 1, 1942, were the charges which were suspended, and which New York was ordered to cease and desist from making, by the Commission's Order of June 16, 1942, herein.

9. The accounting which has been performed by New York with respect to the acquisitions here in question was improper. As has been found, the amounts paid by New York to A. T. & T., its parent company, for the transferred property were recorded by New York in its plant accounts at amounts in excess of the book cost,

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[12] The "original cost" so assumed reflected the amounts at which the property was retired by A. T. & T. and did not necessarily reflect the actual original cost of the property at the time it was first dedicated to the public use. In addition, much of the physical property was originally acquired from the Western Electric Company, Inc., a wholly owned subsidiary of A. T. & T. To the extent that Western may have made a profit by the furnishing of such property the "original cost" so used include an intercompany profit which should ultimately be eliminated.

[13] Section 31.171 of the Commission's Rules and Regulations.

[14] Section 31.172 of the Commission's Rules and Regulations.

less related depreciation and amortization reserves (net book cost), shown on the books of A. T. & T. These excess amounts represented a "profit" to A. T. & T. Since New York was, as it is now, a wholly-owned subsidiary of A. T. & T., and therefore fully subject to control by A. T. & T., the intercompany profits to A. T. & T. resulting from the affiliated company transfers of property involved here are fictitious or paper increments, and are as unreal as profits from interdepartmental transactions. The accounting performed by New York with respect to these property transfers resulted in a write-up of its accounts by the amount of such intercompany profits, and, therefore, in the inclusion of purely inflationary items in New York's accounts. The transfer of the property from the parent A. T. & T. to the subsidiary New York, should not be permitted to convert the excess amounts over A. T. & T.'s net book investment from a fictitious intercompany profit to an investment in assets by New York. Upon consolidation of the affiliated company accounts, such intercompany profits should be eliminated. This was recognized by witnesses presented by New York, who were members of a firm of auditors regularly employed by A. T. & T. If the amounts of such fictitious profits are allowed to remain in New York's accounts they may become real profits to the affiliated group of companies by improper inclusion as a part of the cost of service. Since transfers of property were made in both directions between New York and A. T. & T. at prices in excess of the net book investment of each transferor
95 company, the combined surplus of the companies was increased, not as a result of any increase in income or property, not as a result of any change in the service rendered, but simply as a result of the accounting based upon fictitious sales and unnecessary transfers of unreal cash profits.[15] The passage of time can lend no sanction to improper accounting. Whenever errors in accounting are discovered, they should be corrected. The inflationary writeups found herein should, therefore, never have been recorded in New York's accounts, and should now be forthwith eliminated from New York's accounts.[16]

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[15] Nothing contained in this report should, however, be construed as approval of the amount of A. T. & T.'s net investment as recorded on its books.

[16] In view of this conclusion, it is unnecessary to consider the propriety of the accounting performed by New York on its assumption that Account 100.4 was to be used for the acquisitions here in question. We point out, however, that Account 100.4 and the method to be followed under the System of Accounts in reclassifying the accounts with respect to property acquisitions, as outlined by Section 31.2–21 of the accounting Rules and Regulations of this Commission, specifically require that the amounts includible in Account 100.4 shall reflect the difference between (1) the original cost, after deduction of the appropriate reserve requirements for depreciation and amortization, and (2) the amounts paid. No distinction is made in the accounting rules as between acquisitions prior to January 1, 1937, and those after that date. New York's failure to make any credit entries to Account 171 to reflect the reserve requirement for depreciation of acquired property, and to deduct the amount of such reserve requirement from original cost, in determining the amounts includible in its Account 100.4 results in the inclusion of insufficient amounts in that account.

10. Respondent contends that the amounts paid to its parent company, A. T. & T., as a result of the acquisitions of telephone property here under consideration were fair and reasonable and were not in excess of the fair and reasonable value of the property acquired; that after reclassifying its accounts, as of January 1, 1937, as outlined above, appropriate amounts were entered in its Account 100.4, and the entries to operating expense accounts for the purpose of amortizing amounts so included in Account 100.4 have been made in accordance with a plan approved by the Commission; and that therefore no other entries, and specifically no entry to its surplus Account 413, in the amount of $4,166,510.57, are required or appropriate under the Commission's Uniform System of Accounts. Respondent also asserts that the recording in its plant accounts of the full amounts paid to A. T.
96 & T. was in accordance with the accounting rules and practices prescribed by the Interstate Commerce Commission
at the time of the respective property acquisitions; and that since the "structural value" of the property, as measured by reproduction cost new less actual depreciation, was equal to or more than such amounts so paid, the "prices" were fair and reasonable. Other contentions are advanced which are either subsidiary to those outlined above or are plainly irrelevant to a determination of the issues in this proceeding.[17] All of these contentions ignore the important fact that New York was and is a wholly owned subsidiary of A. T. & T. The fact of this ownership by A. T. & T., carrying with it the power to control New York, makes the fairness and reasonableness of the "prices" paid in such a transfer of property between such affiliated companies completely unrealistic. There was and could be no arms'-length bargaining between A. T. & T. and New York with respect to the amounts so paid. Any method of accounting which results in the inclusion in plant investment accounts of amounts based upon "values" agreed upon between a wholly owned subsidiary and its parent would nullify accounting from a regulatory standpoint. The full ultimate impact of such inflationary elements in the plant accounts is in time improperly reflected in the depreciation expense account as an alleged operating cost, unless, by proper regulatory requirements, the balance-sheet is cleared, or in the first instance is kept free, of such inflationary elements. Accounting, for purposes of efficient regulation of public utilities, must be firmly grounded on the cost principle, and if investment is to have some relationship to the investment dedicated to the public use by an affiliated group of companies, such agreed

[17] New York relies heavily on statements of the United States Supreme Court in American Telephone and Telegraph Co. v. U. S. et al., 299 U. S. 232, and the record in that case, with respect to the disposition of items included in Account 100.4. This position assumes that the items in question were properly recorded in Account 100.4. Such items should never have been recorded in that Account.

"values" must not be allowed to exist as a distortive element in their investment accounts. That the "value" of property transferred between affiliates can ever be represented by any amount greater than legitimate net book investment to the original affiliated owner is at best an illusion born of accounting aberrations existing during the period of the 1920's. Certainly such "values" cannot be represented by an estimate of such an inherently speculative nature as reproduction cost less depreciation.[18]

97 Respondent's assertions as to the method of accounting followed at the time of the property acquisitions here involved being in accordance with accounting rules and practices prescribed by the Interstate Commerce Commission and in effect at that time are not supported by the record. There is nothing in the Uniform System of Accounts for Telephone Companies, effective January 1, 1913, prescribed by the Interstate Commerce Commission and in effect during the period 1925 through 1928, requiring or authorizing the recording of property acquisitions from affiliates at any amount greater than the net book investment of the transferring affiliate. Instruction 13 of that system of accounts, relied upon by New York, was not intended to be applicable to tranfers of property between affiliates such as those involved here.[19] As we read the provisions of the Uniform System of Accounts for Telephone Corporations prescribed by the Public Service Commission, Second District, State of New York, effective January 1, 1912, as amended on March 17, 1921,[20] the

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[18] The highly speculative nature of estimates of reproduction cost less depreciation is illustrated by the following defects in respondent's showings and offers of proof in this respect: The reproduction cost new figures were based in part upon prices of the Western Electric Company, Inc., another wholly owned subsidiary of A. T. & T., without elimination of Western Electric profits. Such reproduction cost figures were based upon costs to A. T. & T. rather than the generally lower costs of New York. The amount deducted for depreciation was inadequate in that there was a failure to make adequate allowance for obsolescence and inadequacy. The character of this latter proof was such that it is entitled to little if any weight. The amount paid for the instruments was based upon Western Electric prices with an arbitrary deduction of 20% from the gross calculated price. The 20% was grossly inadequate when compared with the depreciation reserve of approximately 50% accrued by A. T. & T. as depreciation applicable to the instruments.

[19] As early as 1914, and in subsequent correspondence, the New England Telephone and Telegraph Company, an Associated Bell System company, and A. T. & T. requested rulings by the Interstate Commerce Commission as to whether Instruction 13 of the I. C. C. system of accounts applied to the accounting for transfers of property between affiliated companies of the Bell System, the companies contending that it did not. The Interstate Commerce Commission replies stated specifically that Instruction 13 was not intended to apply to the affiliated company transfers submitted to it. Mr. C. D. Crandall, present Director of the I. C. C. Bureau of Accounts, confirmed the position of the I. C. C. as stated in such early correspondence.

[20] The pertinent provisions of Section 7 of the General Instructions contained in the New York System of Accounts read as follows:

"7. Plant and equipment and other property purchased.—When any telephone line or part thereof (excepting new or used material and supplies) is purchased for a lump sum, an appraisal of the property so acquired shall be made, classifying the various constituent elements in the property according to the accounts prescribed by this Commission in its Uniform System of Accounts for Telephone Corporations. The actual money value of the consideration given for the plant or other property purchased shall be distributed to such accounts in accordance with the appraisal, but in no case shall the values assigned to tangible fixed capital accounts exceed the cost to reconstruct such plant and equipment at prices in effect at the time of purchase, *and when there is substantial identity of interest between the vendor and the vendee the values assigned to tangible fixed capital accounts shall not exceed the original cost of such property to the vendor. The estimated accrued depreciation on property purchased shall be set upon the books of the vendee as an offsetting liability to the cost of property so acquired.* * * *" [Italics supplied.]

accounting performed by New York with respect to the property acquisitions here involved was contrary to such provisions.

98 11. Respondent asserts that insofar as amounts in its accounts with respect to the property which was acquired from A. T. & T. have been retired from New York's books the amounts of write-ups or inflationary items have been removed from its accounts, and that therefore no charges to surplus are now necessary or appropriate to eliminate such amounts. But the credits to plant accounts and debts to reserve accounts made by New York to reflect the retirement of portions of the acquired property did not remove the inflationary items from its accounts. Those items are still included in its accounts, either in its Account 100.4, or as a deficiency in its depreciation reserve Account 171, or a combination of both. The deficiency in New York's depreciation reserve account results from the existence of debits made to and included in such reserve account, in recording the retirement of the acquired property, in amounts in excess of the original cost to A. T. & T. of such retired property less the related depreciation reserves. These debit amounts were included in New York's depreciation reserve account despite the fact that insufficient credits had been made to such reserve account for purposes of retirement of such property.[21]

12. New York's amortization of the debit amounts included in its Account 100.4 by charges to its operating expense accounts, and its amortization of the credit amounts included in that account by credits to its operating expense accounts, were begun in 1938 without any prior direction, authorization, or approval having been given to New York by this Commission. Such action was improper, even on the basis of New York's assumption that the amounts being so amortized were properly recorded in Account 100.4. Subsection (c) of Account 100.4 requires that the amounts included in that account be disposed of, written off, or amortized as directed by the Commission. Account 614, the operating expense account to which such amortization charges and credits were made by New York, permits such charges or credits only when authorized by the Commission.[22] On July 12, 1939,

[21] In cases where telephone plant was retired, and sufficient depreciation had not been provided by credits to the depreciation reserve account, instruction 23 of the 1913 Interstate Commerce Commission System of Accounts required that the amount of deficiency be written off through charges to Account 413, "Realized Depreciation not Covered by Reserves," a Corporate Surplus or Deficit account. No such charges to Account 413 were made by respondent in connection with its retirement of any of the acquired property involved herein. This Commission's prescribed Account 413, "Miscellaneous debits to surplus," among other things, serves the same purpose as the I. C. C. system's Account 413 and Instruction 23.

[22] Account 614 reads as follows: "§ 31.614 Amortization of telephone plant acquisition adjustment.—This account shall be charged or credited, each month with such amounts as may be authorized by the Commission to be included in operating expenses under a plan to amortize amounts in Account 100.4, 'Telephone plant acquisition adjustment.' Amounts so entered shall be charged or credited, as appropriate, to Account 172, 'Amortization reserve.'"

99 the Commission adopted its Order No. 60 in which the Commission allowed all telephone companies to dispose of any debit amounts includible in Account 100.4 by charges to surplus, or by amortization over a reasonable period through charges to Account 323, "Miscellaneous income charges,"[23] without further direction or approval by the Commission. The order also directed companies desiring another manner of disposition of such debits amounts to request "that the Commission approve the recommended disposition or direct appropriate disposition according to the circumstances involved in each transaction." Disposition of credit amounts was ordered to be "as the Commission may approve or direct." Appropriate reservation was made to require subsequent disposition by charges to surplus or to alter the previously determined amortization periods.[24] No direction, authorization or approval has ever been given to New York by this Commission to dispose of amounts in Account 100.4 by amortization through charges or credits to Account 614, or any other operating expense account. As our findings herein show, no such direction, authorization, or approval would have been appropriate. We find that the amoritization through operating expenses of the amounts included in New York's Account 100.4, which amortization was begun by New York in 1938, was in violation of the Commission's Accounting Rules and Regulations, particularly Subsection (c) of Account 100.4, Account 614, and Order No. 60. Complete rectification of such amortization entries since 1938 by reversal thereof will not be required because Respondent's accounts for the years 1938 through 1941 have been closed. Our order of June 16, 1942, herein suspended such entries made on and after January 1, 1942, however, pending disposition of this matter, and our order herein permanently prohibiting such amortization entries will therefore relate back to that date.

Conclusions

13. We are of the opinion and we find and conclude that:

(1) Respondent has failed to show that the amount of $4,166,510.57 should not be charged to its Account 413, with concurrent entries to appropriate accounts; and we further find and conclude that such amount should be charged (debited) to its Account 413;

100 (2) Concurrent with such charge to Account 413, entries should be made (a) to eliminate the amounts presently in-

[23] Section 31.323 of the Commission's Rules and Regulations.

[24] Case 10, Accounting Circular No. 5 (August 16, 1939), Accounting Bulletin No. 1, also made it clear that net amounts in Account 100.4 resulting from debit and credit amounts relating to different transactions, could not be disposed of without direction or approval by the Commission.

cluded in respondent's Account 100.4, associated with New York's acquisitions from A. T. & T. on November 1, 1925, September 1, 1926, and December 31, 1928, by credits to the Account; (b) to eliminate the amounts presently included in Account 172, associated with such acquisitions, with contra entries to Account 171; (c) to adjust the balances in Account 100.1, and the related primary plant Account 231, "Station apparatus," to reflect the original cost of the surviving telephone instruments acquired by New York from A. T. & T. on December 31, 1927, by Debits to those accounts in the amount of the difference between such original cost and the surviving amounts recorded in such Accounts; and (d) to adjust the balance in Account 171, to reflect appropriately the elimination of the intercompany profit or write-up of $4,166,-510.57 resulting from the accounting performed by New York at the time of and during the period since such acquisitions, with respect to and as a result of such acquisitions, by credits to that Account equal to the difference between the amounts debited to Account 100.1 and Account 413, and the amounts credited to Account 100.4;

(3) Respondent has violated the Commission's Accounting Rules and Regulations by failing to reclassify its accounts in accordance with the requirements of such Rules and Regulations, and by making unauthorized entries in its accounts for the purpose of amortizing through charges and credits to its operating expense accounts amounts it has included in its Account 100.4;

(4) Respondent has failed to justify the charges and credits it has made to its operating expense accounts for the purpose of, or in conjunction with, amortizing or otherwise disposing of amounts included in its Account 100.4; and respondent should permanently reverse such charges made on and after January 1, 1942, and should cease and desist from making any such charges or credits to its operating expense accounts, except as otherwise specifically directed, authorized, or approved by the Commission.

14. An appropriate order will issue.

FEDERAL COMMUNICATIONS COMMISSION,
T. J. Slowie,
T. J. SLOWIE, *Secretary*.

Adopted June 22, 1943.

"Released: June 26, 1943. See Section 1.231 of the Commission's Rules of Practice and Procedure."

102 Before the Federal Communications Commission,

Washington, D. C.

P-30—Docket No. 6329

IN THE MATTER OF NEW YORK TELEPHONE COMPANY, ACCOUNTING

Exceptions of New York Telephone Company to and request for oral argument on the proposed report of the Commission

July 16, 1943

Comes now the respondent New York Telephone Company and files these exceptions to the proposed report of the Commission issued in the above matter under date of June 26, 1943. Respondent excepts to the findings and conclusions in said Report in the following particulars:

1. Paragraph 4 of said proposed report states:

"Much of the acquired property was in the form of an additional interest in toll lines owned jointly by New York and A. T. & T. Portions of such acquired property had been originally constructed by New York and transferred to A. T. & T. at amounts equivalent to cost of construction."

103 This statement is excepted to for the following reason:

The statement is misleading. The uncontradicted evidence shows that the portions of the acquired property referred to were jointly engineered and were constructed for the joint account of the two companies (R. 56–59).

2. Paragraph 4 of said proposed report states:

"In accounting for the transactions the property acquired by New York was retired on the books of the Long Lines Department, at what A. T. & T. considered to be its book cost to A. T. & T. in the amount of $5,134,342.49; and an amount of $820,452.93 was charged (debited) to the depreciation and amortization reserve accounts of the Long Lines Department as the estimated allocation of the book reserves of the Long Lines Department related to that property. The amount paid by New York to A. T. & T. was, therefore, $1,659,551.91 in excess of the book cost less the related depreciation and amortization reserves, as reflected on the books of A. T. & T. On December 31, 1927, New York acquired certain telephone instruments from A. T. & T. The instruments acquired consisted of all of the principal operating parts of the telephone subscribed stations (receivers, trans-

mitters and induction coils) in use at the time by New York. The amount paid by New York to A. T. & T. was $6,661,238.91. In accounting for this transaction A. T. & T. retired the instruments on its books at what it considered to be book cost to it, in an amount of $8,135,224.98; and an amount of $3,980,944.73 was charged (debited) to its depreciation reserve account for
104 telephone instruments as the estimated allocation of such reserve related to those instruments. The amount paid by New York to A. T. & T. was, therefore, $2,506,958.66 in excess of the book cost less the related depreciation reserve, as reflected on the books of A. T. & T."

This statement is excepted to for the following reason:

The statement is irrelevant to any issue properly and duly raised by the Commission's order initiating this proceeding and is irrelevant to the order to show cause and the Commission is without authority in law to consider the same even if true. Aside from the issue as to the fair and reasonable value of the property acquired (which issue as respondent's answer pointed out is necessarily raised by the order to show cause), the only issue fairly raised by the Commission's order to show cause was the propriety of respondent's accounting entries at the time of and subsequent to said acquisitions.

3. Paragraph 5 of said proposed report states:

"At the time of the respective acquisitions from A. T. & T., referred to above, New York recorded in its plant accounts as cost of telephone plant purchased the amounts paid to A. T. & T. No entries were made in New York's depreciation or amortization reserve accounts in connection with such acquisitions. Nor were special depreciation rates thereafter applied to the amounts recorded in New York's plant accounts with respect to such acquired property, but the current depreciation rates applicable to the respective classes of plant were applied to such amounts as long as such property remained in service."

105 This statement is excepted to for the following reasons:

(a) The statement is misleading in that it implies that in determining the depreciation rates applicable to the respective classes of plant involved the New York Company did not take into consideration the fact that property acquired had already spent part of its service life. Such is not the case. The undisputed evidence shows that consideration was given to such factor in computing the depreciation rates and the rates thereafter used were deemed adequate after giving effect to the shorter life of the property acquired (R. 311–314).

(b) The statement ignores the facts shown by the undisputed evidence that respondent's depreciation reserve account is in all

respects adequate to meet its reserve requirements (R. 122, 1470–1473).

(c) No provision of the effective accounting system required the application of special depreciation rates to the property acquired.

4. Paragraph 6 of said proposed report states:

"The system further provides that Account 100.4 'Telephone plant acquisition adjustments,' shall include amounts 'representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and
106 similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the properties acquired.' 'Original cost' as used in Accounts 100.1 to 100.4, inclusive, is defined in the System of Accounts by Section 31.01–3 (x) of the Rules and Regulations as 'the actual money cost of (or current money value of any consideration other than money exchanged for) property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors.'"

Paragraph 7 of said proposed report states:

"An attempt was made to determine the amounts of the requirements for depreciation and amortization of such surviving plant, necessary in addition to the future accruals over the estimated remaining life at the current depreciation rates of the respective plant classes, and an amount of $271,280.98 was transferred in 1937 from New York's Account 171, 'Depreciation reserve,' to its Account 172, 'Amortization reserve.' Neither this amount nor any other amount was subtracted from the assumed original cost of such surviving plant as the reserve requirements for depreciation and amortization of such plant in determining the amount included in Account 100.4. No amounts were credited to Account 171 in the process of reclassification. At no time has New York reclassified on an original cost basis the amounts in its accounts associated with its acquisition of the telephone instruments from A. T. & T. in 1927. No amounts were or are included in Account 100.4 as a result of that transaction."

These statements are excepted to for the following reasons:

(a) The statement that respondent at the time of re-
107 classification attempted to determine the amounts of the depreciation requirements for the surviving plant is unsupported by the record. The record shows that respondent transferred from Account 171 to Account 172 an amount which

when supplemented by future amortization charges at uniform rates would provide a reserve equivalent to the amount of the investment carried in Account 100.4 at the termination of the life of the related property (R. 101, 421).

(b) The statements ignore the fact that the accounting system has been construed by the Commission in their brief in the case of A. T. & T. et al. v. U. S., 299 U. S. 232, to mean that the reclassification required by the new system was only a redistribution of the balances in Account 100 existing as of the effective date of the F. C. C.'s new system of accounts, that such construction was adopted by the U. S. Supreme Court and is binding upon the Commission.

(c) The statements are misleading in that they ignore the provisions of Instruction 21 which make it clear that only the amounts in the plant accounts representing an acquisition of a substantially complete telephone system, exchange or toll line should be accounted for on an original cost basis.

(d) The statements ignore the fact shown by the evidence in the record that the telephone instruments are not a substantially complete telephone system, exchange or toll line within the meaning of Instruction 21 and that, therefore, they were required to be accounted for at the price paid (Exs. 69, 70; R. 155–162, 431–433).

108 5. In footnote numbered 12 to paragraph 7 of said proposed report the statement is made:

"In addition, much of the physical property was originally acquired from the Western Electric Company, Inc., a wholly owned subsidiary of A. T. & T. To the extent that Western may have made a profit on the furnishing of such property the 'original costs' so used include an intercompany profit which should ultimately be eliminated."

This statement is excepted to for the following reasons:

(a) The conclusion that the profits of Western Electric should be eliminated from the plant accounts of the New York Company is erroneous for all of the reasons hereinafter stated as to the elimination of profits of the A. T. & T. (see exceptions 6, 7, and 8 herein) made in connection with the transfers in question and for the additional reason that the New York Company had no notice that the propriety of using Western Electric prices was questioned by the Commission (R. 291–294).

(b) There is no proof that Western Electric Company is a wholly owned subsidiary of A. T. & T. The evidence shows that there has been at all times material herein a minority of the stock of Western Electric Company in the hands of the public (R. 294).

(c) Western did not sell its plant or any part thereof to the New York Company. Western is not a utility but a manufactur-

ing and commercial company which has a right to a fair profit from its sales to telephone companies, both Bell System and others.

109 6. Paragraph 7 of said proposed report states:

"The accounting which has been performed by New York with respect to the acquisitions here in question was improper. * * * Since New York was, as it is now, a wholly owned subsidiary of A. T. & T., and therefore fully subject to control by A. T. & T., the intercompany profits to A. T. & T. resulting from the affiliated company transfers of property involved here are fictitious or paper increments, and are as unreal as profits from interdepartmental transactions. The accounting performed by New York with respect to these property transfers resulted in a write-up of its accounts by the amount of such intercompany profits, and, therefore, in the inclusion of purely inflationary items in New York's accounts."

This statement is excepted to for the following reasons:

(a) In this statement and in others throughout the report the purchases of property from A. T. & T. are characterized as a "write-up" and a "fictitious sale" and the accounting as resulting in the inclusion of "inflationary" items or assets in the accounts of the New York Company and in an "unreal" and "fictitious" profit to the A. T. & T. The uncontradicted evidence shows that the purchases in question were necessary to the conduct of important and profitable business of the New York Company and that the New York Company paid no more for the property than the fair and reasonable value at the time of acquisition. (See record references in support of exception 31, infra.)

(b) The conclusion is based upon an enterprise or "economic unit" theory of accounting which has not been pre-
110 scribed by any system of accounts. It ignores the fact that the New York Company and the A. T. & T. are separate corporate entities, subject to differing rights and obligations and keeping separate accounts (Exs. 71–79).

(c) The conclusion ignores the fact that the amounts entered in the New York Company's accounts represent the cost to it of acquiring the property in question and that neither the gross nor the net assets of the New York Company were changed by the purchase. The conclusion is contrary to the undisputed evidence that there was no "write-up of its accounts" in any amount (R. 66–69, 430–431).

(d) The conclusion ignores the fact that the accounting performed at the time of acquisition was in strict accord with the provisions of the Interstate Commerce Commission's system of accounts to which the New York Company was then subject.

7. Paragraph 9 of said proposed report states:

"The transfer of the property from the parent A. T. & T. to the subsidiary New York, should not be permitted to convert the excess amounts over A. T. & T.'s net book investment from a fictitious intercompany profit to an investment in assets by New York. Upon consolidation of the affiliated company accounts, such intercompany profits should be eliminated. This was recognized by witnesses presented by New York, who were members of a firm of auditors regularly employed by A. T. &. T."

111 This statement is excepted to for the following reasons:

(a) The statement that upon consolidation of the affiliated company accounts such intercompany profits should be eliminated is irrelevant to the issues in this proceeding. The New York Company does not consolidate its accounts with those of the A. T. & T. For certain special purposes consolidated statements drawn from the accounts of the two companies are prepared but these do not impair the integrity of the separate accounts kept by each corporation (Exs. 71–79).

(b) The New York Company presented only one witness who was a member of a firm of auditors regularly employed by the A. T. & T., Mr. Schaffer. Mr. Schaffer's testimony is consistent and clear that the principles as to the elimination of intercompany profits applicable to consolidated statements do not apply to the accounting for each corporate entity (R. 1443, 1488).

8. Paragraph 9 of said proposed report states:

"If the amounts of such fictitious profits are allowed to remain in New York's accounts they may become real profits to the affiliated group of companies by improper inclusion as a part of the cost of service."

This statement is excepted to for the following reasons:

(a) The record shows that the profit of the A. T. & T. was not fictitious but real (R. 67).

112 (b) The record shows that the profit has not been included in the New York Company's accounts (R. 63–79).

(c) The inclusion by the New York Company in its accounts of the amount paid for the property not in excess of its value properly represents the fact of its investment and to the extent that such fact is relevant in a determination of its rates for service it is properly so considered (R. 63–79, 343).

(d) The cost of the service of the New York Company to the public has been and will be determined in accordance with the laws of the State of New York as to intrastate rates and in accordance with the laws of the United States as to interstate rates, limited respectively by the due process clauses of the Fourteenth and Fifth Amendments of the United States Constitution. There is no evi-

dence that in the past the accounting performed has enabled the New York Company to charge improper rates. On the contrary, the New York Company would have shown, if its evidence and offer of proof on the subject had not been rejected, that its rates since the time of acquisition have been determined under the applicable laws after full disclosure of all of the details of the transfers in question and that the price paid to A. T. & T. did enter into the rate base (R. 1426–1431). There is no evidence that the accounting performed will enable the New York Company to collect improper rates in the future. On the contrary, the Commission's proposed accounting by misrepresenting the facts of the transactions will result in impeding the New York Company in securing proper rates.

113 9. Paragraph 9 of said proposed report states:

"Since transfers of property were made in both directions between New York and A. T. & T. at prices in excess of the net book investment of each transferor company, the combined surplus of the companies was increased, not as a result of any increase in income or property, not as a result of any change in the service rendered, but simply as a result of the accounting based upon fictitious sales and unnecessary transfers of unreal cash profits."

This statement is excepted to for the following reasons:

(a) It is irrelevant and prejudicial. The order to show cause in this proceeding gave no notice that the sale by the New York Company to the A. T. & T. was in question and A. T. & T. Company has not been made a party to this proceeding.

(b) There is no evidence in the record as to the details of the sale from the New York Company to the A. T. & T.

(c) There is no evidence that any of the sales in question were fictitious. On the contrary, such evidence as was permitted to go into the record shows that the sales were actual and were necessary to the efficient telephone operation of each company (31–34, 470–480, 1214–1215).

(d) As pointed out above, the accounting did not result in any unreal profits. No such profits were transferred by either company and the finding by the Commission in that respect is without evidentiary support in the record.

114 10. Paragraph 9 of said proposed report states:

"The inflationary write-ups found herein should, therefore, never have been recorded in New York's accounts, and should now be forthwith eliminated from New York's accounts."

This statement is excepted to for the following reasons:

(a) As is pointed out above, there is no proof that the accounting in question did result in an inflationary write-up. On the

contrary, the uncontradicted evidence shows that there was no such write-up (R. 31–34, 1214–1215).

(b) The evidence shows that the accounting in question was required by the Interstate Commerce Commission's System of Accounts then in effect (R. 63–79, 343. See also record references to exception 31, infra).

(c) The conclusion ignores the fact shown by the evidence that a large part of the property acquired has already been retired from service by the New York Company and the amount of its investment therein eliminated from its accounts at the price paid (Exs. 61, 62, 64, 67).

11. In footnote 16 to paragraph 9 of the said proposed report, it is stated:

"New York's failure to make any credit entries to Account 171 to reflect the reserve requirement for depreciation of acquired property, and to deduct the amount of such reserve requirement from original cost, in determining the amounts includable
115 in its Account 100.4 results in the inclusion of insufficient amounts in that account."

This statement is excepted to for the following reason:

This interpretation of the Commission's System of Accounts is contrary to the interpretation put upon such system of accounts by the Commission in its brief before the United States Supreme Court in A. T. & T. et al. v. U. S., 299 U. S. 232, which interpretation was accepted by the Court in its opinion and is binding on the Commission.

12. Footnote 17 of paragraph 10 of said proposed report contains the statement:

"New York relies heavily on statements of the United States Supreme Court in American Telephone and Telegraph Co. v. U. S. et al., 299 U. S. 232, and the record in that case, with respect to the disposition of items included in Account 100.4. This position assumes that the items in question were properly recorded in Account 100.4. Such items should never have been recorded in that Account."

The last sentence of this statement is excepted to for the following reasons:

(a) The statement is contrary to the provisions of the F. C. C. System of Accounts.

(b) The statement is contrary to the position and interpretation of the requirements of the system of accounts with respect to Account 100.4 made by the Commission in the case above referred to.

116 (c) The statement is contrary to the interpretation of the system of accounts made by the accountants testifying

for the Commission in this proceeding (R. 1151, 1605; R. 1696–1697).

(d) Regardless of the particular accounting prescribed by the Commission, the rule of law announced in statements of the U. S. Supreme Court in A. T. & T. et al. v. U. S. precludes the Commission from compelling the companies to write out of their accounts amounts representing investments in assets of continuing value and the evidence in the record shows that the amounts now in the plant accounts, including Account 100.4, of the New York Company, attributable to the property remaining in service of that acquired in the purchases in question do represent an investment by the New York Company in assets of continuing value.

13. Paragraph 10 of said proposed report, after enumerating certain of the contentions of respondent, states:

"Other contentions are advanced which are either subsidiary to those outlined above or are plainly irrelevant to a determination of the issues in this proceeding."

This statement is excepted to for the following reason:

The Commission failed to specify the "other contentions" to which reference is made. Without attempting to enumerate all the contentions which the respondent makes the respondent
117 excepts to the blanket ruling that all of its contentions, other than those "outlined" by the Commission or which are subsidiary to those "outlined," are irrelevant.

14. Paragraph 4 of said proposed report states:

"A. T. & T. has at all times material to this proceeding controlled New York through its ownership of 100% of New York's Common stock."

Paragraph 10 of said proposed report states:

"The fact of this ownership by A. T. & T., carrying with it the power to control New York, makes the fairness and reasonableness of the 'prices' paid in such a transfer of property between such affiliated companies completely unrealistic. There was and could be no arms'-length bargaining between A. T. & T. and New York with respect to the amounts so paid."

These statements are excepted to for the following reasons:

(a) The implication is made that because of the fact that A. T. & T. owns 100% of New York's common stock the corporate entities of the two companies should be disregarded. This conclusion is erroneous. There is no evidence in the record which supports or tends to support the conclusion that the New York Company is a mere instrumentality of the A. T. & T. The two companies have separate boards of directors, bondholders, creditors, subscribers, etc. (Exs. 71–79; R. 439–449). The New York Company on and after the dates of the acquisitions in question

118 had outstanding 250,000 shares of preferred stock, none of which was owned by the A. T. & T. (R. 707, 1288, Annual Reports of New York Company to I. C. C. and F. C. C. for the years 1925–1942).

(b) To the extent that the Commission's report rests upon the conclusion that the corporate entities of the two companies should be disregarded, the report is without foundation in the evidence and is unauthorized by law.

(c) The conclusion that there can be no fair or reasonable price between affiliated companies is contrary to fact and law. Even assuming, as the Commission does, that there can be no arms'-length bargaining between the A. T. & T. and the New York Company, it does not follow that there can be no sales of property between such companies or that the price agreed upon in such sales cannot be found reasonable when tested by objective standards such as the value of the property transferred.

15. Paragraph 10 of said proposed report states:

"Any method of accounting which results in the inclusion in plant investment accounts of amounts based upon 'values' agreed upon between a wholly owned subsidiary and its parent would nullify accounting from a regulatory standpoint. The full ultimate impact of such inflationary elements in the plant accounts is in time improperly reflected in the depreciation expense account as an alleged operating cost, unless, by proper regulatory requirements, the balance-sheet is cleared, or in the first instance is kept free, of such inflationary elements. Accounting for purposes of efficient regulation of public utilities, must be
119 firmly grounded on the cost principal, and if investment is to have some relationship to the investment dedicated to the public use by an affiliated group of companies, such agreed 'values' must not be allowed to exist as a distortive element in their investment accounts."

This statement is excepted to for the following reasons:

(a) Insofar as it refers to values arrived at by arbitrary agreement of the parties without relation to the true value of the property, the statement has no application to the transfers in question. The question of value is not, in the final analysis, a matter of agreement between the parties but a question of objective fact to be proved by evidence. Such evidence as respondent was permitted to introduce in this proceeding demonstrated that the price which it paid for the property acquired was not more than the property was worth (see record references in support of Exception 31, infra).

(b) The implication that the accounting followed by the New York Company constituted a departure from the cost prin-

ciple of accounting is erroneous. It is undisputed that the New York Company entered the property here in question in its plant accounts at the cost to it (R. 66–69, 430–431). The suggested procedure by the Commission constitutes a departure from the cost principal of accounting and is based upon theories of enterprising accounting, i. e. accounting for an economic unit as distinguished from accounting for an individual company.

(c) The conclusion that the accounting followed by the
120 New York Company would improperly reflect inflationary amounts in its depreciation expense account as an alleged operating cost is in error in view of the fact that cost to the New York Company not in excess of value has been entered in the plant accounts against which depreciation rates are applied (R. 66–69, 430–431: See also record references to exception 31, infra).

16. Paragraph 10 of said proposed report states:

"That the 'value' of property transferred between affiliates can ever be represented by any amount greater than ligitimate net book investment to the original affiliated owner is at best an illusion born of accounting aberrations existing during the period of the 1920's."

This statement is excepted to for the following reason:

The statement is erroneous in fact and law. There is no necessary relationship between the value of the property at the time of transfer and the cost to the original affiliated owner. If the statement is intended to mean that fundamental accounting principles prohibit any purchase price, not in excess of the value of the property transferred, from being reflected on the books of the purchasing company, the statement is contrary to law and without substantial support in the evidence.

17. Paragraph 10 of said proposed report, speaking of the value of property purchased from an affiliated company, states:
121 "Certainly such 'values' cannot be represented by an estimate of such an inherently speculative nature as reproduction cost less depreciation."

This statement is excepted to for the following reason:

The statement is contrary to fact and to the law as it existed at the time of the acquisitions in question and as it exists today.

18. Footnote 18 of paragraph 10 of said proposed report states:

"The highly speculative nature of estimates of reproduction cost less depreciation is illustrated by the following defects in respondent's showings and offers of proof in this respect: The reproduction cost new figures were based in part upon prices of the Western Electric Company, Inc., another wholly owned subsidiary of A. T. & T., without elimination of Western Elec-

tric profits. Such reproduction cost figures were based upon costs to A. T. & T. rather than the generally lower costs of New York. The amount deducted for depreciation was inadequate in that there was a failure to make adequate allowance for obsolescence and inadequacy. The character of this latter proof was such that it is entitled to little if any weight. The amount paid for the instruments was based upon Western Electric prices with an arbitrary deduction of 20% from the gross calculated price. The 20% was grossly inadequate when compared with the depreciation reserve of approximately 50% accrued by A. T. & T. as depreciation applicable to the instruments."

122 This statement is excepted to for the following reasons:

(a) Respondent was told by the hearing Commissioners that the question of Western Electric prices would not be gone into in this proceeding (R. 291–294).

(b) The evidence shows that the reproduction cost figures were not based solely upon the cost of the A. T. & T. or those of the New York Company but in every instance were based upon the costs which the engineers estimated would be incurred at that time irrespective of which of the two companies performed the work. There is no evidentiary support in the record for the statement that the New York Company costs were generally lower than those of the A. T. & T. In the comparatively few instances in which higher unit costs as developed from the experience of the A. T. & T. were used rather than lower unit costs of the New York Company, the record shows that the reason the A. T. & T. unit costs were used was that they had been developed from construction work reflecting the conditions under which the property being purchased would be constructed while the New York Company unit costs were developed from construction work under different conditions (R. 369, 374–377).

(c) The statement that there was an inadequate allowance made for obsolescence and inadequacy has no support in the evidence.

(d) The statement that the 20% deduction from prices for the instruments new was inadequate when compared with the depreciation reserve at the A. T. & T. is misleading. The evi-
123 dence shows that the 20% deduction was greater than the depreciation existing in the instruments (Exs. 19, 48, 51; R. 492–500, 908–934, 1079–1083). The value of the instruments was properly determined by deducting such existing depreciation from the prices new rather than by deducting the depreciation reserve which the A. T. & T. had accumulated against such instruments.

19. Paragraph 10 of said proposed report states:

"Respondent's assertions as to the method of accounting followed at the time of the property acquisitions here involved being in

accordance with accounting rules and practices prescribed by the Interstate Commerce Commission and in effect at that time are not supported by the reord. There is nothing in the Uniform System of Accounts for Telephone Companies, effective January 1, 1913, prescribed by the Interstate Commerce Commission and in effect during the period 1925 through 1928, requiring or authorizing the recording of property acquisitions from affiliates at any amount greater than the net book investment of the transferring affiliate. Instruction 13 of that system of accounts, relied upon by New York, was not intended to be applicable to transfers of property between affiliates such as those involved here."

The statement is excepted to for the following reasons:

(a) The statement that respondent's assertion of compliance with the accounting rules of the I. C. C. is not supported by the record implies that the question turns upon a disputed issue
124 of fact. This implication is incorrect. There is no dispute as to the method of accounting followed at the time of the property acquisitions here involved. Such accounting complied literally with the method prescribed in Instructions 10 and 13 of the I. C. C.'s System of Accounts for Telephone Companies, effective January 1, 1913, the only disputed question being whether those instructions were confined to purchases of property from nonaffiliates. Since the pertinent provisions of the I. C. C. System of Accounts are clear and unambiguous their interpretation is a ~~matter of law, not of fact.~~ Consequently the receipt by the hearing Commissioners over objection of respondent's counsel of extrinsic evidence to interpret such provisions and their refusal to allow respondent to introduce rebuttal evidence was improper (659–660, 1405–1410, 1421–1426). The Commission's interpretation of the applicable accounting requirements of the I. C. C. is erroneous as a matter of law.

(b) There is no evidence that the I. C. C. intended that Instructions 10 and 13 be limited to purchases from non-affiliates. On the contrary the evidence shows that those instructions were intended to mean what they said (Ex. 31; R. 1410, 1517–1518, 1665, 1793–1795, 1912–1913, 1594–1595, 1869–1876).

(c) The record shows that at the times in question there was neither any provision of the I. C. C. System of Accounts nor any accounting rule prescribed by such Commission which required or permitted different accounting for purchases from affiliated companies than that prescribed or permitted for purchases from nonaffiliated companies (Ex. 31; R. 1410, 1517–1518, 1665, 1793–1795, 1912–1913, 1594–1595, 1869–1876).

125 20. Footnote 19 of paragraph 10 of said proposed report states:

"As early as 1914, and in subsequent correspondence, the New England Telephone and Telegraph Company, an associated Bell System company, and A. T. & T. requested rulings by the Interstate Commerce Commission as to whether Instruction 13 of the I. C. C. system of accounts applied to the accounting for transfers of property between affiliated companies of the Bell System, the companies contending that it did not. The Interstate Commerce Commission replies stated specifically that instruction 13 was not intended to apply to the affiliated company transfers submitted to it."

This statement is excepted to for the following reason:

The statement is an erroneous representation of the contents of the correspondence in question. The Bell System companies in these letters did not obtain rulings or interpretations by the Interstate Commerce Commission. In every instance but one they merely requested a waiver of the enforcement of such provisions in the circumstances of certain specified transfers. In that one case the company requested the adoption of a general rule differing from that provided in the system of accounts applicable to all transfers where certain conditions were met, but its request for such a rule was refused (Exs. 26–39).

21. Paragraph 10 of said proposed report states:

"As we read the provisions of the Uniform System of Ac-
126 counts for Telephone Corporations prescribed by the Public Service Commission, Second District, State of New York, effective January 1, 1912, as amended on March 17, 1921, the accounting performed by New York with respect to the property acquisitions here involved was contrary to such provisions."

This statement is excepted to for the following reasons:

(a) The Federal Communications Commission has no power to interpret or enforce the System of Accounts of the New York Public Service Commission. Its attempt to do so is, therefore, beyond its jurisdiction and contrary to the Communications Act.

(b) If this statement is intended to imply that the New York Company violated the System of Accounts prescribed by the Public Service Commission the statement is erroneous for the reason that the New York Company, being subject to the provisions of the System of Accounts prescribed by the Interstate Commerce Commission, was not subject to the provisions of the System of Accounts prescribed by the New York Public Service Commission above referred to.

(c) The evidence in the record does not support the conclusion that there is a "substantial identity of interest" between the New York Company and the A. T. & T. within the meaning of the rule of the New York Public Service Commission quoted in foot-

note 20 to paragraph 10 and referred to in the above quoted statement of the proposed report.

(d) The reference by the Commission to this rule in the text of its proposed report (whether as an additional ground
127 for any or all of its conclusions, or as a gratuitous comment) is improper in view of (1) the refusal of the hearing Commissioners to permit respondent to offer proof of the federal commissions' exclusive accounting jurisdiction (R. 1341–1357) and (2) of the refusal of the hearing Commissioners of either Commission in this proceeding to inform respondent's counsel upon his request therefor, of their respective Commissions' claims on the jurisdictional issues thus raised (R. 1343, 1355–1357).

22. Paragraph 11 of said proposed report states:

"Respondent asserts that insofar as amounts in its accounts with respect to the property which was acquired from A. T. & T. have been retired from New York's books the amounts of write-ups or inflationary items have been removed from its accounts, and that therefore no charges to surplus are now necessary or appropriate to eliminate such amounts. But the credits to plant accounts and debits to reserve accounts made by New York to reflect the retirement of portions of the acquired property did not remove the inflationary items from its accounts. Those items are still included in its accounts, either in its Account 100.4, or as a deficiency in its depreciation reserve Account 171, or a combination of both. The deficiency in New York's depreciation reserve account results from the existence of debits made to ~~and included~~ in such reserve account, in recording the retirement of the acquired property, in amounts in excess of the original cost to A. T. & T. of such retired property less the related depreciation reserves. These debit amounts were included in New York's depreciation reserve account despite the fact that insufficient
128 credits have been made to such reserve account for purposes of retirement of such property."

The statement is excepted to for the following reasons:

(a) Respondent has not asserted and does not admit that there have been any "write-ups" or "inflationary items" entered in its accounts.

(b) There is no evidence in the record tending to support the conclusion of the Commission that the credits to its plant accounts and debits to its reserve account made by the New York Company upon retirement of portions of the acquired property did not remove from its accounts the amounts originally entered therein attributable to the plant purchased, even if such amounts had been inflationary.

(c) There is no evidence in the record to support the statement that there is a deficiency in the New York Company's depreciation

reserve account. On the contrary, the uncontradicted evidence tends to show that there is a surplus in such reserve account (R. 122).

(d) The company's offer of detailed proof as to the adequacy of its reserve was erroneously rejected by the Commission as irrelevant to the issues in the case (Ex. 65, R. 1254–1262, 1269).

(e) There is no evidence in the record supporting or tending to support the assertion that insufficient credits have been made to such reserve account for the purposes of retiring the property.

129 (f) While there is no evidence in the record to show what depreciation had been accrued against the particular items of property purchased and subsequently retired, such absence of proof does not warrant the conclusion that insufficient credits have been made to the reserve account. The Company kept no separate reserve for individual items of plant or even for classes of plant and the rates for accruals credited to the reserve are and have in the past been computed on an average basis. The evidence shows that those rates took into consideration the fact that property acquired had already served part of its useful life (R. 306–315).

(g) The conclusion that an adjustment should be made to depreciation reserve by reason of the acquisitions in question regardless of the over-all adequacy of the reserve is erroneous. An order directing such an entry would be arbitrary, would constitute retroactive accounting and would be in violation of the Communications Act of 1934 and the due process clause of the Fifth Amendment of the United States Constitution.

(h) The conclusion that the respondent's depreciation reserve account should be increased despite the adequacy of such reserve account, is contrary to law. Such an order would be an attempt, in the guise of an accounting regulation, to interfere unlawfully with the management of the company and would be beyond the jurisdiction of the Commission under the provisions of the Communications Act of 1934 and in violation of the due process clause of the Fifth Amendment of the United States Constitution.

130 23. Footnote 21 of paragraph 11 of said proposed report states:

"In cases where telephone plant was retired, and sufficient depreciation had not been provided by credits to the depreciation reserve account, instruction 23 of the 1913 Interstate Commerce Commission System of Accounts required that the amount of deficiency be written off through charges to Account 413, 'Realized Depreciation not Covered by Reserves,' a Corporate Surplus or Deficit account. No such charges to Account 413 were made by respondent in connection with its retirement of any of the acquired

property involved herein. This Commission's prescribed Account 413, 'Miscellaneous debits to surplus,' among other things, serves the same purpose as the I. C. C. system's Account 413 and Instruction 23."

This statement is excepted to for the following reasons:

(a) There is no evidence in the record which shows that Instruction 23 had application to a "deficiency" in credits to the depreciation reserve for particular property. The instruction therefore has not been shown to have any applicability to the accounting involved in the present proceeding.

(b) Account 413 of the F. C. C. System of Accounts does not require the companies subject to such System of Accounts to make charges to surplus where the amount of depreciation accrued against particular items of plant was not sufficient to cover the retirement of such items of plant.

131 24. Paragraph 12 of said proposed report states:

"New York's amortization of the debit amounts included in its Account 100.4 by charges to its operating expense accounts, and its amortization of the credit amounts included in that account by credits to its operating expense accounts, were begun in 1938 without any prior direction, authorization, or approval having been given to New York by this Commission. * * * No direction, authorization or approval has ever been given to New York by this Commission to dispose of amounts in Account 100.4 by amortization through charges or credits to Account 614, or any other operating expense account. As our findings herein show, no such direction, authorization, or approval would have been appropriate. We find that the amortization through operating expenses of the amounts included in New York's Account 100.4, which amortization was begun by New York in 1938, was in violation of the Commission's Accounting Rules and Regulations, particularly Subsection (c) of Account 100.4, Account 614, and Order No. 60."

This statement is excepted to for the following reasons:

(a) The conclusion that the amortization referred to was commenced without any prior direction, authorization, or approval of the Commission is not supported by the evidence. On the contrary, the evidence shows that the amortization was made pursuant to a plan approved by the Commission (Ex. 4, R. 102–105; 109–131).

(b) There is no evidence in the record to support the
132 conclusion that approval of such plan of amortization was not appropriate. The record shows that under the "binding construction" (sometimes referred to in the record as a "stipulation" or "interpretation") filed by the Commission with the United States Supreme Court in A. T. & T. et al. v. United

States, 299 U. S. 232, such approval was required to be given upon a showing that the amounts being amortized represented an investment in assets of continuing value definitely attributable to depreciable telephone plant (Ex. 3). Respondent in his proceeding was denied an adequate opportunity to show that the amounts entered in its Account 100.4 did represent an investment in assets of continuing value definitely attributable to depreciable telephone plant with respect to property acquired from A. T. & T. (R. 504, 538, 606, 703, 706, 712, 748, 887–906, 1032–1035, 1282).

(c) The conclusion that Commission approval of the amortization of amounts in Account 100.4 would not be appropriate is broad enough to include amortization of amounts in such account attributable to acquisitions from telephone companies other than the A. T. & T. As to such acquisitions respondent has been given no opportunity to show that the amounts in Account 100.4 attributable to such acquisitions represent an investment in assets of continuing value definitely attributable to depreciable telephone plant.

(d) The conclusion that the amortization begun by the New York Company in 1938 was in violation of Subsection (c) of Account 100.4 Account 614, and Order No. 60, rests upon the assumption that such amortization was begun without the prior approval of the Commission. This is contrary to the evidence in the record (Ex. 4, R. 102–105, 109–131).

133 25. Footnote 24 of Paragraph 12 of said proposed report states:

"Case 10, Accounting Circular No. 5 (August 16, 1939), Accounting Bulletin No. 1, also made it clear that net amounts in Account 100.4 resulting from debit and credit amounts relating to different transactions, could not be disposed of without direction or approval by the Commission."

This statement is excepted to for the following reason:

It is irrelevant to any of the issues in this proceeding.

26. Paragraph 2 of said proposed report states:

"Although a hearing is not a prerequisite to action by the Commission under Section 220 of the Act, a hearing was ordered, with provision for its conduct jointly with hearings involving similar matters before the New York and Connecticut State Commissions."

This statement is excepted to for the following reasons:

(a) The conclusion of law that a hearing is not a prerequisite to action by the Commission under Section 220 of the Act is erroneous insofar as it refers to action such as suggested in the proposed report. Such a hearing is required by the provisions

of the Communications Act of 1934 and by the due process clause of the Fifth Amendment of the United States Constitution.

134 (b) While the statement that a hearing was ordered is correct, the implication that a fair and impartial hearing such as is required under the statute and the provisions of the Federal Constitution has been granted is erroneous. The respondent has been denied a fair hearing in the following respects among others:

(1) The hearing Commissioners prejudged the issues and demonstrated partiality and bias in their rulings (R. 2038, 2087, Record references to exception 26 (b) (2) to (b) (6), infra).

(2) Respondent was denied the opportunity to introduce competent, material and relevant evidence upon the issues in this proceeding (R. 504, 538, 606, 703, 706, 712, 748, 887–906, 935–943, 952–979, 993, 1032–1035, 1282, 1254–1262, 1269, 1426, 2107, 345, 2122. Exs. 15, 17, 20, 47, 49, 50, 65, 66, 68).

(3) The Commission excluded evidence offered by the company while admitting evidence of a similar character offered by Commission counsel (R. 1112–1121, 1404–1410, 1724, 1889, 1948).

(4) The Commission permitted the introduction as evidence of incompetent and highly prejudicial statements of witnesses presented by Commission counsel over objections of respondent (1122–1159, 1531–1532).

(5) Respondent was not permitted to mark for identification documents which were relevant and which were not identifiable or sufficiently identifiable by statement, thereby denying respondent an opportunity to preserve the rulings of the hearing Commissioners and the exceptions of respondent therefor for purposes of review by the full Commission and the courts (R. 1648–1652, 2038–2043, 2114–2126).

135 (6) Respondent's counsel was in certain instances not permitted to state the grounds for the exceptions which respondent took to rulings by the examining Commissioners (R. 1795–1797, 1955–1956).

27. Paragraph 2 of said proposed report states:

"Under Section 220 of the Act respondent has the statutory burden of justifying the accounting entries questioned by the Commission."

Paragraph 13 of said proposed report states:

"Respondent has failed to show that the amount of $4,166,-510.57 should not be charged to its Account 413, with concurrent entries to appropriate accounts; and we further find and conclude that such amount should be charged (debited) to its Account 413;"

These statements are excepted to for the following reasons:

(a) The provision contained in the Communications Act of 1934 as to burden of proof was not contained in the Interstate Commerce Act and does not apply to accounting entries made prior to the effective date of the Communications Act.

(b) The burden imposed upon the respondent by Section 220 is limited to the burden of going forward with the evidence. This burden was met by respondent to the extent that it was permitted by the hearing Commissioners so to do.

(c) The record hearings and the proposed report show
136 that respondent was not given an adequate opportunity to go forward with the evidence, that the Commission gave no consideration to the evidence which was introduced by respondent and prevented it from introducing other relevant and competent evidence. (See record citations to exception 26.)

(d) The implication that the respondent has the burden of proving that the accounting entries suggested by the Commission should not be made is erroneous. The burden rested upon the Commission to show that the entries which it proposed are required by the valid provisions of the effective system of accounts or other provisions of law. This burden has not been sustained. On the contrary uncontradicted evidence shows that no amount should be charged to respondent's account 413. The evidence shows that the amounts attributable to the purchase in question reflected in respondent's asset accounts represent an investment in assets of continuing value and that the respondent's depreciation reserve is adequate. (See record citations to exception 31.)

(e) The conclusion of the Commission that the charge of $4,166,510.57 should be charged to respondent's account 413 is based upon the conclusion that the accounting of the New York Company at the time of the acquisition in question was improper and not in accord with the uniform system of accounts prescribed by the I. C. C. and upon the further conclusion that the retirement of the amounts recorded in its plant accounts at the time the property was retired from service would not to that extent remove alleged "inflationary items." Since the subsidiary conclusions as heretofore specified are erroneous, the ultimate conclusion is without foundation in the record.

137 (f) Any order directing such a charge to respondent's Account 413 would compel the respondent to misstate its present and future financial condition and operations, would prevent it from keeping proper and accurate accounts, would be so at odds with fundamental principles of correct accounting as to be arbitrary, would interfere unlawfully with respondent's right to manage its own business, would be without authority in the Communications Act of 1934, as amended, and would deprive respond-

ent of its property in violation of the due process clause of the Fifth Amendment of the United States Constitution.

28. Paragraph 13 of said proposed report states:

"Concurrent with such charge to Account 413, entries should be made (a) to eliminate the amounts presently included in respondent's Account 100.4, associated with New York's acquisitions from A. T. & T. on November 1, 1925, September 1, 1926, and December 31, 1928, by credits to the Account; (b) to eliminate the amounts presently included in Account 172, associated with such acquisitions, with contra entries to Account 171; (c) to adjust the balances in Account 100.1 and the related primary plant Account 231, 'Station apparatus,' to reflect the original cost of the surviving telephone instruments acquired by New York from A. T. & T. on December 31, 1927, by Debits to those accounts in the amount of the difference between such original cost and the surviving amounts recorded in such Accounts; and (d) to adjust the balance in Account 171, to reflect appropriately the elimination of the intercompany profit or write-up of $4,166,510.57 resulting from

138 the accounting performed by New York at the time of and during the period since such acquisitions, with respect to and as a result of such acquisitions, by credits to that Account equal to the difference between the amounts debited to Account 100.1 and Account 413, and the amounts credited to Account 100.4;"

This statement is excepted to for the following reasons:

(a) This conclusion is based upon the conclusions that the accounting at the time of the original acquisitions was improper and contrary to the Uniform System of Accounts prescribed by the Interstate Commerce Commission and upon the further conclusion that the retirement of the amounts recorded in respondent's plant accounts at the time the property was retired from service did not, to that extent, remove the alleged "inflationary items." Since the subsidiary conclusions as heretofore specified are erroneous the ultimate conclusion is without foundation in the record.

(b) Any order directing the accounting entries described in the above statement would compel the respondent to misstate its present and future financial condition and operations and would be so at odds with fundamental principles of correct accounting as to be arbitrary, would interfere unlawfully with respondent's right to manage its own business, would be without authority in the Communications Act of 1934, as amended, and would deprive respondent of its property in violation of the due process clause of the Fifth Amendment of the United States Constitution.

139 29. Paragraph 13 of said proposed report states:

"Respondent has violated the Commission's Accounting Rules and Regulations by failing to reclassify its accounts in ac-

cordance with the requirements of such Rules and Regulations, and by making unauthorized entries in its accounts for the purpose of amortizing through charges and credits to its operating expense accounts amounts it has included in its Account 100.4";

This statement is excepted to for the following reason:

The conclusion that respondent has violated the Commission's accounting rules and regulations is unsupported by the evidence in the record and is contrary to such evidence. (See record citations to exceptions 11, 23, and 24.)

30. Paragraph 13 of said proposed report states:

"Respondent has failed to justify the charges and credits it has made to its operating expense accounts for the purpose of, or in conjunction with, amortizing or otherwise disposing of amounts included in its Account 100.4; and respondent should permanently reverse such charges made on and after January 1, 1942, and should cease and desist from making any such charges or credits to its operating expense accounts, except as otherwise specifically directed, authorized, or approved by the Commission."

140 This statement is excepted to for the following reasons:

(a) There is no evidence in the record supporting or tending to support this conclusion. On the contrary, uncontradicted evidence shows that the amounts in Account 100.4 attributable to plant acquired in the three acquisitions from the A. T. & T. represent an investment in assets of continuing value definitely attributable to depreciable telephone plant and therefore under the "binding construction" filed in the United States Supreme Court in A. T. & T. et al. v. U. S., 299 U. S. 232, the amortization of such amounts through operating expenses is appropriate, and such amortization which has been made should not be reversed, and respondent should be permitted to continue the amortization of such amounts through operating expenses. (See record citation to exception 31.)

(b) As to the amounts in Account 100.4, attributable to plant acquired from telephone companies other than the A. T. & T., respondent has been denied an opportunity to show that these amounts represent an investment in assets of continuing value definitely attributable to depreciable telephone plant, and until such opportunity is afforded, respondent should not be required to reverse any amortization of such amounts, and should not be required to cease or desist from making such charges through its operating expense accounts in the future.

(c) Any order directing respondent to reverse permanently the charges referred to or prohibiting respondent from making such charges in the future would compel the respondent to mis-

141 state its present and future financial condition and operations and would be so at odds with fundamental princi-

ples of correct accounting as to be arbitrary, would interfere unlawfully with respondent's right to manage its own business, would be without authority in the Communications Act of 1934, as amended, and would deprive respondent of its property in violation of the due process clause of the Fifth Amendment of the United States Constitution.

31. Respondent excepts to the failure of the Commission to adopt each of the following findings of fact proposed by the respondent in this proceeding.

1. The New York Telephone Company (hereinafter called the New York Company) is and at all times mentioned herein was lawfully engaged in intrastate, interstate, and foreign communication by wire or radio within the State of New York and elsewhere. Its average annual operating revenues have exceeded $50,000, at all times mentioned herein.

2. The Interstate Commerce Commission from January 1, 1913 until July 11, 1934 (the effective date of the Communications Act), and the Federal Communications Commission from July 11, 1934, to date, have prescribed the forms of accounts of and the methods of accounting to be followed by the New York Company (R. 1435–1436).

3. For several years prior to 1925 both the New York Company and the American Telephone and Telegraph Company (hereinafter called the American Company) owned and operated intrastate toll lines in the State of New York (R. 475).

142 4. The New York Company and the American Company at all times mentioned herein have been separate and distinct corporate entities and have had separate directors, officers, employees, bondholders, creditors and subscribers (Exs. 71–78).

5. The intrastate toll business handled by the American Company over its intrastate toll lines in the State of New York prior to 1925 was a profitable portion of the total intrastate telephone business in the State of New York and the transfer of such business was reasonable and proper both as to the New York Company and as to its subscribers (R. 475–480).

6. On June 1, 1925 and November 1, 1925, the American Company transferred to the New York Company a large part of its intrastate toll business in the State of New York (R. 31–33).

7. As of November 1, 1925, the American Company sold to the New York Company for a consideration of $5,831,884.78 a portion of its intrastate toll lines needed to handle the intrastate toll business transferred to the New York Company in 1925 (R. 31–33, 62).

8. As of September 1, 1926, the American Company transferred to the New York Company the remaining portion of its intrastate toll business and in connection therewith sold to the New York

Company for a consideration of $97,310.39 the additional intrastate toll lines required to handle that business (R. 34).

9. As of December 31, 1928, the American Company transferred to the New York Company a portion of its interstate toll business in the State of New York and in conjunction there-
143 ~~with sold to~~ the New York Company for a consideration of $44,246.30 the portion of an interstate toll line needed to handle certain of that business (R. 1214–1215).

10. The major classes of plant included in the purchases described in Findings Nos. 7, 8, and 9 consisted of poles, crossarms, guys and anchors, aerial wire and cable, underground cable, loading coils, conduit and right-of-way (Ex. 1).

11. From January 1, 1913, to January 1, 1933, the effective System of Accounts prescribed by the Interstate Commerce Commission for telephone companies subject to the Interstate Commerce Act and having average annual operating revenues in excess of $50,000, provided as follows:

"13. Plant and Equipment and Other Property Purchased.—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, 'Other Intangible Capital,' and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be
144 distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts (R. 1435–1436). * * *"

12. In the instance of each purchase described in Findings Nos. 7, 8, and 9 an appraisal was made by the New York Company of the property purchased and the constituent elements of the plant at appraised structural value as defined in Instruction 13 set forth in Finding No. 11 (Ex. 1, R. 1214–1215).

13. The appraisals were made by experienced and well qualified inspectors and engineers using the following method:

Traffic engineers estimated the number of circuits which would be needed to handle the business transferred. Plant engineers then determined what plant would be required from the American

Company in order to obtain the circuits which the traffic engineers estimated would be needed. A check by plant employees was made which determined that the plant which it was proposed to purchase from the American Company corresponded with the plant found in the field. Reproduction new unit costs for each item of plant being purchased were developed by appraisal engineers using current prices for material, labor and overhead costs. The unit costs thus developed were then applied against the quantities of plant as determined by the plant engineers to obtain the reproduction cost new of the plant needed.

To obtain the deduction for deterioration, a field inspection of the property was made and the extent of deterioration
145 due to wear and tear observable and calculable was noted and recorded. Plant engineers familiar with the character of the property being purchased and with any prospective retirements of such property estimated the quantity which would be retired for any reason other than wear and tear, sooner than property being built for similar purposes at the time of purchase. Plant which it was estimated would be retired within a year from the time of acquisition was not purchased but rented. Other plant which it was estimated would have a shorter life than normal was purchased but the estimated deterioration from reproduction cost new by reason of these factors was properly calculated and recorded. The total deduction made from estimated reproduction cost new was obtained by adding the computed amount for deterioration from wear and tear and the computed allowance for short life plant (R. 36, 44–47, 272–306, 356–367, 526–572, 577–645, 713–774, 776–872, 881–886, 1170–1219).

14. The price paid by the New York Company for the toll plant purchased as above stated was in each instance the structural value as defined in Instruction 13 set forth in Finding No. 11 (R. 66–68, 310).

15. The total amount paid by the New York Company for the toll lines purchahed was distributed through the plant accounts in proportion to the appraised value of the constituent elements appropriate to the respective accounts (R. 66–69).

16. For many years prior to December 31, 1927, the American Company contracted to and did supply and maintain for the New York Company three small but essential parts of the telephones used by the New York Company in its service, namely, the
146 transmitters, receivers and induction coils, known collectively as "the instruments." For this and many other services the New York Company paid the American Company a specified percentage of its gross revenues (R. 160–163, 483–485).

17. The instruments described in Finding No. 16 did not comprise a substantially complete telephone system, exchange or toll line (Exs. 69, 70, R. 155–162, 431–433).

18. On December 31, 1927, the American Company sold to the New York Company the instruments which the New York Company had in service or in supplies on that date, for a total consideration of $6,661,238.91. The American Company thereupon discontinued its service of supplying such instruments after December 31, 1927, and the percentage of gross revenues which the New York Company was required to pay for this and other services under the license contract was reduced from 4% to 2% (Ex. 18, R. 483–487).

19. From January 1, 1913, to January 1, 1933, the effective System of Accounts prescribed by the Interstate Commerce Commission for telephone companies subject to the Interstate Commerce Act and having average annual operating revenues in excess of $50,000, provided in part as follows:

"10. COSTS TO BE ACTUAL MONEY COSTS.—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. When the consideration actually given for anything with respect to which a charge is made to any fixed capital or other property account is anything other
147 than money, the actual consideration should be described in the entry with sufficient fullness and particularity to identify it, and the amount charged should be the actual money value of such consideration at the time of the transaction." (R. 1435–1436).

20. Effective July 1, 1916, the Interstate Commerce Commission issued the following interpretation of the System of Accounts described in Findings No. 11 and 19:

"Query.—What items should be classified as 'going or completed plant' under section 13, page 33, 'Plant and equipment and other property purchased' of the Uniform System of Accounts for Class A and B companies?

Answer.—The term 'going or completed plant' is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—

(1) A telephone company as a whole,
(2) An entire central office,
(3) A system of lines and stations within a given area, or
(4) A complete section of toll plant.

The purchase by one company from another of several poles and appurtenances, a switchboard, or other minor portions of plant shall be treated in the same manner as the purchase of materials and supplies; i. e., the purchasing company shall charge the fixed capital accounts at cost, as provided in section 10, page 33, of the Uniform System of Accounts for Class A and B companies." (R. 1435–1436.)

148 21. The price per instrument to the New York Company was based upon the average price charged for new instruments by the manufacturer to the American Company during the first nine months of 1927 less 20% (R. 512, 943).

22. The percentage deterioration due to wear and tear, inadequacy and obsolescence in the instruments purchased by the New York Company was at the time of such purchase considerably less than the 20% deduction made. (Exs. 19, 48, 51; R. 492–500, 908–934, 1079–1083.)

23. The total amount paid by the New York Company for the instruments in service was entered in its plant accounts (R. 430–431).

24. The amounts entered in the plant accounts of the New York Company as a result of the purchases described in Findings Nos. 7, 8, 9, and 18 constituted investments by the New York Company in assets of continuing value and were attributable to depreciable telephone plant. (R. 31–36, 44–47, 272–306, 356–367, 492–500, 526, 572, 577–645, 713–774, 776–872, 881–886, 908–934, 1079–1083, 1170–1219.)

25. For some years prior to the date of the acquisition of the property as herein described and continuing through until the present time, the New York Company has charged depreciation expense for each class of depreciable plant including the classes of plant purchased and made corresponding credits to its depreciation reserve. The depreciation expense has been determined by applying to the book balances in each account deprecia-
149 tion rates estimated to be adequate under the straight line method on the basis of the service lives and salvage developed by studies of the New York Company's history and experience and such engineering and other information as was available. (R. 75–78, 311–312, 420, 1470–1473.)

26. During this same period the New York Company has credited its plant accounts and debited its depreciation reserve with the cost of plant which has been retired from service. (R. 1139, 1464.)

27. The depreciation and amortization reserves of the New York Company at the present time are more than adequate to meet its estimated reserve requirements. (R. 122, 1470–1473.)

28. Of the toll property purchased from the American Company as of November 1, 1925, September 1, 1926, and December 31, 1928, $3,002,382.48 or 50.26% had been retired from service on January 1, 1937, and $2,971,058.99, or 49.74% remained in service on that date. On January 1, 1942, $3,361,855.08 or 56.28% had been retired from service and $2,611,586.39 or 43.72% remained in service on that date. (Exs. 58, 62, 63, 64; R. 1220–1242.)

29. Of the instruments purchased from the American Com-

pany on December 31, 1927, $4,228,133.50 or 63.47% had been retired from service on January 1, 1937 and $2,433,105.41 or 36.53% remained in service on that date. On January 1, 1942, $6,030,959.78 or 90.54% had been retired from service and $630,279.13, or 9.46% remained in service on that date. (Ex. 67; R. 1360–1377.)

150 30. As of January 1, 1937, the plant accounts of the New York Company were reclassified. The original cost (as defined in Section 3 (S1) of the Federal Communications Commission's Uniform System of Accounts, Class A and Class B Telephone Companies) of property surviving on that date from acquisitions comprising a substantially complete telephone plant purchased since January 1, 1916, where the consideration paid was in excess of $25,000, was placed in Account 100.1 and the difference between original cost and the balance carried in the plant accounts on that date was entered in Account 100.4. Included in the property so reclassified was the surviving toll line plant purchased from the American Company as of November 1, 1925, September 1, 1926, and December 31, 1928. The net amount debited to Account 100.4 by reason of the adjustment of these three purchases was $483,975.83. The instruments surviving from those purchased from the American Company on December 31, 1927, were not included in the property reclassified. (R. 69–72, 102, 431).

31. In the latter part of 1937 and during the year 1938 the New York Company informed the Federal Communications Commission of the reclassification as it was entered on its books, giving the date of purchase, the name of the utility from whom purchased and the amounts which had been transferred to Account 100.4 as a result of the reclassification, together with the method used in determining the same. (Ex. 79; R. 1805–1808.)

32. The reclassification described in Finding No. 30 met with the approval of the Federal Communications Commission and of its Chief Accountant. (Ex. 4, R. 1938, 1951.)

151 33. Mr. C. A. Heiss, Comptroller of the American Company, on behalf of the New York Company and other Bell System Companies wrote to the Federal Communications Commission in 1937 and 1938, proposing a plan to amortize the amounts placed in 100.4 by reason of the reclassification described in Finding No. 30 to Account 614, an operating expense account. (Ex. 4; R. 109–131.)

34. The Federal Communications Commission gave its approval to the plan proposed by Mr. Heiss, which approval continued in effect until the order of the Commission commencing this proceeding. Pursuant to that plan and the approval obtained thereto, the New York Company commenced in December 1938 to amortize the amounts included in Account 100.4 to Account 614 and con-

tinued to do so until ordered to cease such amortization in the order to show cause in this proceeding. (Ex. 4; R. 102–105, 109–131.)

35. The officers, directors, and accounting employees who have been responsible for the accounting performed by the New York Company in respect to and as a result of the acquisitions of telephone property described in Findings Nos. 7, 8, 9, and 18 have understood that such accounting was in accord with the effective systems of accounts and orders of the Interstate Commerce Commission and the Federal Communications Commission. (R. 109–131.)

36. During the years 1938 to 1941, inclusive, the New York Company amortized through operating expenses $64,814.46 of the amounts place in Account 100.4 as a result of the reclassification of the surviving toll property purchased from the American
152 Company as of November 1, 1925, September 1, 1926, and December 31, 1928. (Ex. 12.)

37. The Federal Communications Commission at the request of the United States Supreme Court, October Term 1936, in Case No. 74 entitled "American Telephone and Telegraph Company, et al. v. United States" filed with the court a memorandum adopting the following as a binding construction of the provisions of Account 100.4 of its Uniform System of Accounts for Class A and Class B Telephone Companies:

"The Federal Communications Commission construes the provisions of Telephone Division Order No. 7–C, issued June 19, 1935, pertaining to account 100.4, as follows:

(1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provisions will be made for their amortization.

(2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 186) or account 675 (R. 205)." (Ex. 3.)

32. Respondent excepts to the failure of the Commission to adopt each of the following conclusions proposed by respondent in this proceeding:

153 1. The New York Company from January 1, 1913, to January 1, 1937, was subject to the Uniform Systems of Accounts for Class A and Class B Telephone Companies prescribed by the Interstate Commerce Commission and from Jan-

uary 1, 1937, to date has been subject to the Uniform System of Accounts for Class A and Class B Telephone Companies prescribed by the Federal Communications Commission. During that period it has been prohibited by law from following any other system of accounts except that it has been permitted to keep subaccounts not impairing the integrity of the primary accounts.

2. The New York Public Service Commission at no time since January 1, 1913, has possessed any power or authority to prescribe the forms of the accounts of or the method of accounting to be followed by the New York Company except as to certain subaccounts as described in Conclusion No. 1.

3. The Interstate Commerce Commission System of Accounts for Class A and Class B Telephone Companies effective from January 1, 1913, to January 1, 1933, required that where going or completed plant was purchased, the actual money value of the consideration paid or given therefor should be entered in the fixed capital accounts if not in excess of the structural value of the property acquired. The System of Accounts made no distinction between purchases from affiliated companies and purchases from nonaffiliated companies.

4. The actual money value of the consideration paid for the toll
plant purchased by the New York Company from the
154 American Company as of November 1, 1925, September 1,
1926, and December 31, 1928, was not in excess of the structural value of the property acquired.

5. The instruments purchased by the New York Company from the American Company on December 31, 1927, did not constitute "going or completed plant" as used in Instruction 13 of the Interstate Commerce Commission's Uniform System of Accounts for Class A and Class B Telephone Companies effective January 1, 1913, and did not comprise a "substantially complete telephone system, exchange or toll line" as used in Instruction 21 of the Federal Communications Commission's Uniform System of Accounts for Class A and Class B Telephone Companies effective January 1, 1937.

6. The actual money cost to the New York Company of the instruments purchased from the American Company on December 31, 1927, was not in excess of the fair and reasonable value of the instruments acquired.

7. The accounting performed by the New York Company at the time of and during the period since the four acquisitions of telephone property described in Findings Nos. 7, 8, 9, and 18 with respect to and as a result of such acquisitions has been in accord with the effective systems of accounts and accounting orders prescribed by the Interstate Commerce Commission and the Federal Communications Commission.

8. Any reduction of the investment of the New York Company by a write off to surplus by reason of the accounting performed with respect to and as a result of the transactions described
155 in Findings Nos. 7, 8, 9, and 18 would be retroactive accounting, would constitute a write off of investment by the New York Company in assets of continuing value and would prevent the New York Company from amortizing through operating expenses amounts now in Account 100.4 definitely attributable to depreciable telephone plant and overstate its income.

9. Any reduction of the surplus of the New York Company by reason of the accounting performed with respect to and as a result of the transactions described in Findings Nos. 7, 8, 9, and 18 would be contrary to the Federal Communications Commission's System of Accounts for Class A and Class B Telephone Companies, contrary to the binding construction of that system of accounts filed with the United States Supreme Court, contrary to the provisions of the Communications Act of 1934, contrary to accepted fundamental principles of accounting and would deprive the New York Company of its property without due process of law in violation of the Fifth Amendment of the United States Constitution.

10. The surplus of the New York Company should not be charged with the amount of $4,166,510.57 referred to in the order to show cause herein dated June 16, 1942, or by any amount as the result of its accounting for or in respect of the transactions described in Findings Nos. 7, 8, 9, and 18.

11. The order to show cause in this proceeding should be dismissed, the investigation discontinued, the portion of the order requiring the New York Company to suspend amortization of amounts in Account 100.4 and to cease making such amor-
156 tization through operating expense should be rescinded, and the company should be authorized to continue with the amortization of such amounts through Account 614 as outlined in the plan of amortization proposed to the Federal Communications Commission by Mr. C. A. Heiss as described in Finding No. 33.

Respondent respectfully requests oral argument.

Respectfully submitted.

Ralph W. Brown,
Attorney for Respondent,
New York Telephone Company.

Edward L. Blackman,
Frank A. Fritz,
Stephen H. Fletcher,
Of Counsel.

157 Before the Federal Communications Commission, Washington, D. C.

P-30—Docket No. 6329

IN THE MATTER OF NEW YORK TELEPHONE COMPANY, ACCOUNTING

STATE OF NEW YORK,
County of New York, ss:

Vincent T. Cummiskey, being duly sworn, deposes and says that on the 15th day of July 1943, deponent being more than 21 years of age, mailed in the United States Postoffice at New York City, New York, copies of the annexed exceptions of New York Telephone Company to and request for oral argument on the proposed report of the Commission in the above-entitled matter with full postage prepaid as follows: Public Service Commission, Mr. Murray G. Tanner, Secretary, State Office Building, Albany, New York; Gay H. Brown, Esq., Counsel, Public Service Commission, State Office Building, Albany, New York; John T. Ryan, Esq., Assistant Counsel, Public Service Commission, 80 Centre Street, New York City; Harry Hertzoff, Esq., Assistant Corporation Counsel, City of New York, Municipal Building, New York City.

VINCENT T. CUMMISKEY.

Subscribed and sworn to before me this 15th day of July, 1943.

HERBERT L. LEIGH,
Herbert L. Leigh,
Notary Public, New York County.

N. Y. Co. Clk's No. 249 Reg. No. 352L5; Bronx Co. Clk's No. 27 Reg. No. 124L5; Kings Co. Clk's No. 66 Reg. No. 284L5; Queens Co. Clk's No. 1874 Reg. No. 174L5.

167 United States District Court, Southern District of New York

Civ. 24-211

NEW YORK TELEPHONE COMPANY, PLAINTIFF

v.

UNITED STATES OF AMERICA AND FEDERAL RADIO COMMUNICATIONS COMMISSION, DEFENDANTS

Before THOMAS W. SWAN, Circuit Judge, and JOHN W. CLANCY and JOHN BRIGHT, District Judges

Ralph W. Brown, Esq., 140 West Street, New York City; Frank A. Fritz, Esq., 140 West Street, New York City; Henry J. Friendly,

Esq., 31 Nassau Street, New York City; Attorneys for New York Telephone Company.

Honorable James B. M. McNally, United States Attorney for the Southern District of New York, Attorney for the United States of America.

Charles R. Denny, Esq., General Counsel, Federal Communications Commission, New Post Office Bldg., Washington, D. C.

Opinion

Aug. 24, 1944

Bright, D. J.:

Defendants move for summary judgment on the ground that there is no genuine issue of fact. Plaintiff asks, at this time, no affirmative relief.

Jurisdiction is not questioned, and is established by Section 402 (a) of the Commissions Act of 1934, 48 Stat. 1064, 1093,
168 47 U. S. C. A. Section 402 (a), and by the Urgent Deficiencies Appropriation Act, 38 Stat. 219, 28 U. S. C. A. Section 41 (28) and Sections 46 and 48.

The action is brought to enjoin and annul an order of the Federal Communications Commission dated December 14, 1943, which directed plaintiff to make certain accounting changes in its books, by reducing its surplus by $4,166,510.57 (the excess of payments by plaintiff to American Telephone & Telegraph Company, which we will call the "American Company," for telephone plant purchased by plaintiff from the latter on November 1, 1925, September 1, 1926, and December 31, 1928, and for telephone instruments so acquired on December 31, 1927) over the amount found by the Commission to represent the net book cost of such acquisitions on the books of the American at the time of such purchase; to restate this investment in plant so acquired; to balance these changes by adding to depreciation reserve $3,879,957.94; and to make other entries in its accounts.

At the time of these acquisitions, the American Company owned all of the outstanding common stock of the plaintiff. There were also outstanding in the hands of the public 250,000 shares of plaintiff's 6½% $100 cumulative preferred stock, and in excess of $132,000,000 of mortgage bonds. All of plaintiff's officers, and at least two-thirds of its directors, were not directors, officers or employees of the American Company. It maintained its own books and records, and its employees, property and business were separate and apart from those of the American Company.

Prior to 1925 the American Company had furnished intrastate and interstate toll service between certain points in New York. In that year it was agreed that such business would be transferred

to plaintiff. In order to accomplish that, plaintiff purchased from the American Company certain toll plant, consisting of tangible property such as poles, wires, serials and underground cable rights of way, etc., as of November 1, 1925, September 1, 1926, and December 31, 1928.

Prior to December 31, 1927, the American Company, as holder of the fundamental Bell patents, owned three small but essential parts of the telephone equipment placed with subscribers by plaintiff. These parts were the transmitter, receiver and an induction coil, and were commonly known as the instruments. On that date the American Company sold to plaintiff the instruments then in service or in the supplies of plaintiff, at a price based upon then average price charged the American Company by Western Electric Company, the manufacturer of the instruments, less an allowance of 20% to reflect the condition of the instruments.

The purchase price for the toll plant was agreed upon as being an amount equal to the cost of reproduction less deterioration, determined by a field inspection and detailed appraisal; and that of the instruments was approved by qualified engineers of the plaintiff. A tabulation of these purchases as compared with the book cost to the American Company shows:

169 Total plant	Purchase price	American book cost	American depreciation reserve	American net book cost	Cost of purchase price over net book cost
11/1/25	$5,831,884.78	$5,010,340.19	$801,858.95	$4,208,481.24	$1,623,403.54
9/1/26	97,310.39	95,924.66	14,449.20	81,475.46	15,834.93
12/31/28	44,246.30	28,077.64	4,144.78	23,932.86	20,313.44
	5,973,441.47	5,134,342.49	820,452.93	4,313,889.56	1,659,551.91
Instruments					
12/31/27	6,661,238.91	8,135,224.98	3,980,944.73	4,154,280.25	2,506,958.66
	12,634,680.38	13,269,567.47	4,801,397.66	8,468,169.81	4,166,510.57

At the time of these transactions, plaintiff was a telephone company within the meaning of the Interstate Commerce Act and subject to Section 20 of that Act (24 Stat. 379, 386 as amended by 34 Stat. 584, 598, 594), and was prohibited by that section from keeping any other accounts than those prescribed by the Interstate Commerce Commission. That Commission, on December 10, 1912, prescribed a uniform system of accounts for telephone companies, and that system, as interpreted by the Interstate Commerce Commission, by Instruction 10, provided:

"10. Costs to be actual money costs.—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. * * *"

Instruction 13 of that system provided, in part:

"13. Plant and equipment and other property purchased.—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204. Other Intangible Capital, and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be distributed

170 through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts. * * * *"

The accounting bulletin adopted by the Interstate Commerce Commission on June 26, 1916, provided in case No. 30:

"Query.—What items should be classified as 'going or completed plant' under section 13, page 33, 'Plant and equipment and other property purchased' of the Uniform System of Accounts for Class A and B companies?

"Answer.—The term 'going or completed plant' is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—

(1) A telephone company as a whole.
(2) An entire central office.
(3) A system of lines and stations within a given area, or
(4) A complete section of toll plant.

"The purchase by one company from another of several poles and appurtenances, a switchboard, or other minor portions of plant shall be treated in the same manner as the purchase of materials and supplies: i. e., the purchasing company shall charge the fixed capital accounts at cost, as provided in section 10, page 33, of the Uniform System of Accounts for Class A and B companies."

Plaintiff, purporting to act under Instruction 13, and treating the acquisition of the plant as coming within case No. 30, distributed the $5,973,441.47, which it claimed was the actual cost to it of that property, among its various plant accounts in the precise amount of appraised structural value of the various types

of property purchased; and purporting to act under Instruction 10, recorded the $6,661,238.91, which it claimed to have paid for the instruments, in the plant accounts.

The Interstate Commerce Commission's system of accounts continued in effect until January 1, 1933, on which date a revised system became effective, which continued in force until January 1, 1937, the effective date of the uniform system of accounts for telephone companies prescribed by the defendant Federal Communications Commission. The revision of the system by the Interstate Commerce Commission as of January 1, 1933, did not require any change by the plaintiff in the accounting which it had performed with respect to the transactions in question.

171 The Communications Act of 1934 (48 Stat. 1064; 47 U. S. C. A. Sections 51 et seq.) approved June 19, 1934, became effective upon the organization of the Commission on July 11, 1934, except as to Sections 1 and 4 thereof, which became effective on July 1, 1934; and plaintiff was and is engaged in interstate and foreign communication by wire and radio within the meaning of Section 2 of that Act.

Under that Act, the defendant, Federal Communications Commission, is given power to "Make such rules and regulations, and issue such orders, not inconsistent with this Act, as may be necessary in the execution of its functions," § 4 (1); to "At any time require any such carrier (which, by definition in 3 (h) would include this plaintiff) to file with the Commission a statement showing the original cost at the time of dedication to the public use of all or any part of the property owned or used by said carrier. * * * If the carrier owning the property at the time such original cost is reported shall have paid more or less than the original cost to acquire the same, the amount of such cost of acquisition, and any facts which the Commission may require in connection therewith, shall be reported with such original cost," § 213 (e); to prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act," § 220 (a), and under subdivision (c) of the same section, the "burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by any such person." And under subdivision (g), "After the Commission has prescribed the form and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission.

By Section 604 (a), "All orders, determinations, rules, regulations, * * * which have been issued, made or granted by the Interstate Commerce Commission * * * under any provision of law repealed or amended by this Act, or in the exercise of duties, powers or functions transferred to the Commission by this Act, and which are in effect at the time this Section takes effect, shall continue in effect until modified, terminated, superseded or repealed by the Commission or by operation of law."

On June 19, 1935, the defendant Commission issued telephone division order No. 7-G, which prescribed for the plaintiff and other telephone companies, a system of accounts effective January 1, 1936, which differed from both systems theretofore prescribed by the Interstate Commerce Commission. Insofar as we are now interested, this system of accounts prescribed, as to balance sheet accounts, and investments, that account 100.1. "Telephone plant in service" shall include the original cost (defined in § 31.01-3 (k) as meaning" the actual money cost of * * * property at the time when it was first dedicated to the public use, whether by the accounting party or by predecessors"), of
172 the company's property used in telephone service at the date of the balance sheet; and Account 100.4, "Telephone plant acquisitions adjustment," should include amounts determined in accordance with § 31.2–21 representing the difference between (1) the amount of money actually paid for telephone plant acquired, plus expense of acquisition and (2) the original cost of such plant less the amount of reserve requirements for depreciation and amortization of the property acquired. "(c) The amounts recorded in this Section with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct." Section 21.2–21 relating to telephone plant acquired provided that when substantially complete toll line was acquired from predecessors, and charged to account 276, "Telephone plant acquired," the accounting shall be completed as follows: The original cost shall be charged to the telephone plant accounts as appropriate and credited to Account 276; the reserve requirements for depreciation, and amortization shall be credited to Account 171 "depreciation reserve," and Account 172 "amortization reserve," and debited to Account 276; and the amount remaining in Account 276 shall be debited or credited as appropriate to Account 100.4 "Telephone plant acquisition adjustment," with certain exceptions not important here.

The promulgation of this system of accounts was met by an action in which the American Company and other telephone companies, including this plaintiff, were plaintiffs, and the United States and Federal Communications Commission were defendants,

to enjoin and annul the proposed system. The plaintiffs were almost completely unsuccessful in this court (14 F. Supp. 121), and upon appeal, the Supreme Court affirmed, 292 U. S. 232. In this court, the defendants denied that the definition of original cost would require the plaintiffs to restate as of January 1, 1936, their property investment accounts by eliminating therefrom the recorded cost or investment of the plaintiff in property theretofore acquired from another public utility.

The Statutory Court made findings of fact, in part, as follows: V, that the order 7–C does not require that the recorded cost or investment in plaintiff's property theretofore acquired from another public utility be obliterated or eliminated from their investment accounts, but merely requires the plaintiffs to segregate the element of recorded cost or investment into investment accounts 100.1–2–3–4; VIII, that the order does not prevent plaintiffs from recovering amounts included in accounts 100.4 in view of the alternative provisions in paragraph C, and the Commission has made no direction in paragraph C, and the Commission has made no direction with respect to the disposition of any such accounts; XI, that the order does not require plaintiffs to write off any portion of their actual investment where they had paid in excess of the original cost; XII, does not require plaintiffs to make radical or retroactive changes in their completed accounts, but merely requires the reclassification of balances as of its effective date in certain balance sheet accounts; and XIII, it does not require that amounts recorded in account 100.4 be disposed of, written
173 off, or amortized by plaintiff's the form of accounting to be performed is dependent upon the development of facts in connection with each individual acquisition. And in the 13th conclusion of law, the lower court found that the order was not retroactive in its requirements.

In the Supreme Court, Mr. Justice Cardozo wrote in part:

"The argument is that account 100.4 representing the difference between original and present cost, is not to be reckoned, either wholly or in part, as a statement of existing assets, but must be written off completely. The Commission is charged, we are told, with a mandatory duty to extinguish the entire balance recorded in that account, its presence under the title of 'investments', having the effect of a misleading label. To give support to that conception of official duty, they rely on subdivision (c), which provides, as we have seen, that 'the amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct.'

"If subdivision (c) had the meaning thus imputed to it, there would be force in the contention that the effect of the order is to

distort in an arbitrary fashion the value of the assets. But the imputed meaning is not the true one. The Commission is not under a duty to write off the whole or any part of the balance in 100.4, if the difference between original and present cost is a true increment of value. On the contrary, only such amount will be written off as appears, upon an application for appropriate directions, to be a fictitious or paper increment. This is made clear, if it might otherwise be doubtful, by administrative construction. * * *

"To avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed, we requested the Assistant Attorney General to reduce his statements in that regard to writing in behalf of the Commission. He did this and informs us that 'the Federal Communications Commission construes the provisions of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4' as meaning 'that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.'

174 "We accept this declaration as an administrative construction binding upon the Commission in its future dealings with the companies. * * * The administrative construction now affixed to the contested order devitalizes the objection that the difference between present value and original cost is withdrawn from recognition as a legitimate investment.

"We are not impressed by the argument that the classification is to be viewed as arbitrary because the fate of any item, its ultimate disposition, remains in some degree uncertain until the Commission has given particular directions with reference thereto. By being included in the adjustment account, it is classified as provisionally a true investment, subject to be taken out of that account and given a different character if investigation by the Commission shows it to be deserving of that treatment. Such a reservation does not amount to a departure from the statutory power to fix the forms of accounts for 'classes' of carriers rather than for individuals. The forms of the accounts are fixed, and fixed by regulations of adequate generality. What disposition of their content may afterwards be suitable upon discovery that particular items have been carried at an excessive figure must depend upon evidentiary circumstances, difficult to define or catalogue in advance of the event. If once there was any need for explanation more precise than that afforded by the order, it is now supplied, we think,

by an administrative construction, which must be read into the order as supplementary thereto."

It is to be observed that this case did not decide what power the Commission had other than to order a uniform system of accounts. The order 7–C was clearly found to be within the law as a constitutional and statutory exercise of the powers conferred upon the Commission by the Communications Act of 1934. While appellants in that case complained that the system of accounting might authorize the Commission in the future to do something toward obliterating or striking out the difference between original cost and purchase price, the court refused to adjudicate as to the validity of the system based upon any such anticipated action. It left the determination of that point to be decided upon whatever facts might subsequently be revealed as justifying it. It would seem that the only question here is whether the Commission now has power to direct the debit to surplus and the other charges of which complaint is now made. The other case stopped short of deciding that.

From time to time after the acquisition of the toll plant and instruments, certain units of both have been retired and written out of the plant accounts at the amounts recorded therein and the same amount less salvage has been charged to depreciation reserve. Out of the total plant purchased at a cost of $5,973,441.27, there remained in the plant accounts as of Jan. 1, 1937, toll plant of an estimated book cost of $2,971,058.99, and as of Jan. 1, 1942, an estimated book cost of $2,611,586.39. Out of the instruments
175 purchased at a cost of $6,661,238.91, there remained in the plant accounts as of Jan. 1, 1937, instruments having an estimated book cost of $2,433,105.41, and as of Jan. 1, 1942, an estimated book cost of $630,279.13.

Here the accounting practice followed by the plaintiff, at the time of and for a number of years after the acquisition of the toll plant and instruments, was, in our opinion, in conformity with the rules of the Interstate Commerce Commission. Testimony that it did not follow good accounting practice would be immaterial if the practice followed was within the regulations then in force.

When the "original cost" theory was introduced by the Communications Act of 1934, insofar as telephone companies were concerned, a new system of accounting was devised by the Federal Communications Commission which required for the first time the segregation of the so-called "profit" into an account other than that in which original cost was entered. At that time some portion of the toll plant and instruments had been retired. The right to make the segregation was attacked in the A. T. & T. case, one of

the reasons given being that because segregation was required, the difference between original cost and the alleged purchase price "must be written off completely * * * the Commission is charged * * * with the mandatory duty to extinguish the entire balance recorded in" account 100.4 pursuant to subdivision (C) of that accounting requirement. Mr. Justice Cardozo answered that as above quoted.

The administrative construction referred to, and plainly appearing in the stipulation then filed by the counsel for the Federal Communications Commission, is not present in any of the other cases to which our attention has been called; and this case, for that reason, if for no other, is clearly to be distinguished from those cited. That administrative construction, if none other, it seems to us, precludes the action now taken until (1) there has been a "fair consideration of all the circumstances," and (2) unless the difference between the original and present cost is not "a true increment of value" but is a "fictitious or paper increment"; and action to obliterate must depend upon "evidentiary circumstances" later to be developed.

Here there has been no determination whether the difference between original cost and the price claimed to have been paid is a true increment of value, unless it is the arbitrary determination that it cannot be because it is the result of a transaction between a parent and an affiliate. There might be real doubt to make such a determination if based upon any such theory. New York Edison Co. v. Maltbie, 244 App. Div. 685–689, aff'd 271 N. Y. 103.

The order under review proceeds upon the theory that plaintiff's accounting in question was improper when made and should be corrected. In our opinion the entries made at the time of the four transactions in question accorded with the system prescribed by the Interstate Commerce Commission. They were recorded
176 at "actual money costs," and we do not understand that the
fairness of the appraisals then made is questioned. Defendants' position is that the fairness of the appraisals is immaterial because in transactions between affiliates the transferee is bound to take the transferor's net book cost. But if the entries were correct when made, as we now determine, the defendant Commission, under the present record, cannot apply retroactively a new system to write down the plaintiff's surplus. Arizona Grocery v. Atchison Ry., 284 U. S. 370–389.

That this is so seems all the more true in view of the stipulation of these same defendants made in A. T. & T. v. U. S. supra; certainly in the absence of proof that the excess of price over the seller's net book cost was not a "true increment of value." There has not been any determination based upon a fair consideration of all the circumstances in accordance with the stipulation mentioned,

nor upon the evidentiary circumstances referred to in the opinion of the Supreme Court.

The motion for summary judgment is, therefore, denied.

Dated August 24, 1944.

THOMAS W. SWAN,
U. S. Circuit Judge.
JOHN W. CLANCY,
U. S. District Judge.
JOHN BRIGHT,
U. S. District Judge.

178. In United States District Court

[Title omitted.]

The form of the within order and judgment is approved.

RALPH W. BROWN,
FRANK A. FRITZ,
HENRY J. FRIENDLY,
Attorneys for New York Telephone Company,
(S) By HENRY J. FRIENDLY,
(S) JOHN F. X. MCGOHEY,
U. S. Atty.,
Attorney for United States of America.
(S) HARRY M. PLOTKIN,
Attorney for Federal Communications Commission.

179 In United States District Court, Southern District of New York

Civ. 24–211

NEW YORK TELEPHONE COMPANY, PLAINTIFF

v.

UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, DEFENDANTS

Judgment

Jan. 2, 1945

This cause having come on to be heard upon the motion of plaintiff for final judgment in its favor and against the defendants for the relief demanded in the complaint, pursuant to the direction of this Court by order dated herein on December 28, 1944, it is

Ordered, adjudged, and decreed that the order adopted by defendant Federal Communications Commission under date of December 14, 1943, requiring the above named plaintiff to debit its surplus account in the sum of $4,166,510.57 and to make other

changes in its accounts, as amended by supplemental order dated January 25, 1944, is and has at all times been beyond the lawful authority of said defendant and in violation of the legal rights of the plaintiff and wholly illegal and void, and it is further.

Ordered, adjudged, and decreed that said order be permanently enjoined, set aside, suspended and annulled and that the enforcement thereof be permanently restrained and enjoined, and it is further

Ordered, adjudged, and decreed that, notwithstanding the foregoing, the plaintiff shall continue to maintain its Account No. 180, Surplus Reserved, the said sum of $4,166,510.57 which plaintiff has credited to said account pursuant to the said supplemental order of defendant Federal Communications Commission
180 dated January 25, 1944, until sixty days after the date of the entry of this judgment and if prior to the expiration of such sixty-day period an appeal from this judgment to the Supreme Court of the United States be taken by the defendants, or either of them, the plaintiff shall continue to maintain said sum in its Account No. 180 pending the final determination of such appeal, provided that such appeal be diligently prosecuted.

Dated New York, N. Y., January 2, 1945.

(S) George H. Follmer,
Clerk.

The form of the foregoing judgment is hereby approved and the Clerk of this Court is hereby directed to enter the same.

(S) Thomas W. Swan,
U. S. Circuit Judge.
(S) John W. Clancy,
U. S. District Judge.
(S) John Bright,
U. S. District Judge.

181 — In United States District Court, Southern District or New York

Civ. 24-211

New York Telephone Company, plaintiff

v.

United States of America and Federal Communications Commission, defendants

Findings of fact and conclusions of law

Filed Jan. 2, 1945

The above-named defendants having applied to this Court for summary judgment in their favor, and the said motion having

duly come on to be heard before a Statutory Court constituted under the provisions of the Urgent Deficiencies Appropriation Act, 38 Stat. 219, 28 U. S. C. A. Section 41 (28) and Sections 46 and 48, consisting of Hon. Thomas W. Swan, Hon. John Bright, and Hon. John W. Clancy, convened pursuant to order dated March 17, 1944, and plaintiff and defendants having stipulated in open court that upon the determination of said motion, final judgment might be entered as on a final hearing in favor of the party in whose favor said motion should be decided, and due deliberation having been had thereon, it is

Ordered, that the aforesaid motion of the defendants for summary judgment in their favor be and the same is in all respects denied, and it is further

Ordered, that the Court hereby makes its findings of fact and conclusions of law as follows:

Findings of fact

I. Plaintiff is a corporation duly organized and existing under the laws of the State of New York. Plaintiff has its principal office in the City of New York, State of New York, and in
182 the Southern District thereof. Plaintiff maintains its principal books of account in the City of New York, State of New York, and in the Southern District thereof. Plaintiff has been engaged since its incorporation in 1896, and is now engaged, in the business of furnishing telephone service to the public in the States of New York and Connecticut. In that business it furnishes local or exchange telephone service in towns, cities and other localities in said states. It also furnishes intrastate and interstate toll or long distance service between points in said states and interstate and foreign toll service through physical connection with the lines of other telephone companies between points in said states and points outside thereof.

II. The defendant Federal Communications Commission is an administrative agency created by the Communications Act of 1934 (48 Stat. 1064, 47 U. S. C. A. § 151 et seq.) and is charged with the execution and enforcement of said Act.

III. By an order dated December 14, 1943, defendant Commission directed plaintiff to reduce its surplus account by \$4,166,510.57 which the Commission found to represent the excess of payments by plaintiff to the American Telephone and Telegraph Company (hereinafter referred to as the "American Company") for telephone plant purchased by plaintiff on November 1, 1925, September 1, 1926, December 31, 1927, and December 31, 1928, over the book cost of such telephone plant less an allocated part of the depreciation reserve appearing on the books of the American

Company at the time of acquisition, and to balance such charge to surplus by increasing its plant accounts by an amount of $194,886.97, decreasing its investment account, "Telephone plant acquisition adjustment" by an amount of $481,439.60, and increasing its depreciation reserve by an amount of $3,879,957.94. In an order dated January 25, 1944, the defendant Commission, having regard to this impending action to review its order of
183 December 14, 1943, amended its prior order to extend the time within which the prescribed entries would have to be made until further order of the Commission, upon condition that the $4,166,510.57 ordered to be debited to surplus account be debited to surplus and credited to "surplus reserved" and be held in suspense pending such further order.

IV. At all times material herein the American Company has owned all of the outstanding common stock of the plaintiff. However, plaintiff has maintained its own books, records and accounts separate and distinct from those of the American Company and has also maintained its own employees, property and business separate and apart from the employees, property and business of the American Company. At the time of the acquisitions referred to in Findings V to IX infra, plaintiff had outstanding in the hands of the public 250,000 shares of 6½% cumulative preferred stock and in excess of $132,000,000 of mortgage bonds. All of plaintiff's officers, and at least two-thirds of its directors were not directors, officers or employees of the American Company.

V. Prior to 1925 the American Company had furnished intrastate toll service between certain points in New York. In that year, pursuant to agreement between the plaintiff and the American Company, such business was transferred to plaintiff and in order to conduct the business so transferred the plaintiff purchased from the American Company certain toll plant consisting of tangible property such as poles, cross arms, guys and anchors, aerial wire and cable, underground cable, loading coils, conduit, and right of way. The purchase was effected as of November 1, 1925, and September 1, 1926.

VI. As of December 31, 1928, the plaintiff purchased from the American Company a small amount of additional toll plant which was required in order to handle certain interstate toll business which had been transferred to plaintiff by such company.
184 VII. Prior to December 31, 1927, the American Company as owner of the fundamental Bell Patents owned three small but essential parts of the telephone equipment placed with subscribers by plaintiff. These parts were the transmitter, receiver and an induction coil, and were commonly known as the

"instruments." On December 31, 1927 the American Company sold to plaintiff the instruments then in the service or supplies of plaintiff.

VIII. The purchase price of the toll plant agreed upon was to be an amount equal to its "structural value," i. e., its cost of reproduction new less deterioration, determined by a field inspection and detailed appraisal. Such inspection and appraisal were made by qualified engineers of the plaintiff and the American Company and the plaintiff paid to the American Company a total of $5,973,441.47 shown by the appraisal to be the "structural value" of the property purchased.

IX. The purchase price of the instruments agreed upon was $6,661,238.91 which was based upon the average price charged the American Company by the Western Electric Company, manufacturer of the instruments, during the first nine months of 1927, less an allowance of 20% to reflect the then condition of the instruments. This price was approved by qualified engineers of the plaintiff.

X. The defendant Federal Communications Commission in the proceeding before it resulting in its order dated December 14, 1943, as described in Finding III, supra, made no determination with respect to the value of any of the property purchased by the plaintiff from the American Company and counsel for the defendants in this action, upon oral argument, informed the Court that the Commission was not relying on any claim or over-valuation and that for the purposes of this action no such issue existed.

XI. At the time of the acquisitions referred to in Findings V to IX, supra, plaintiff was a telephone company within the meaning of the Interstate Commerce Act, subject to Section 20 of that Act and was prohibited from keeping any other accounts than those prescribed by the Interstate Commerce Commission.

XII. The Interstate Commerce Commission on December 10, 1912, effective January 1, 1913, prescribed a Uniform System of Accounts for telephone companies subject to its jurisdiction under Section 20 of the Interstate Commerce Act. This system continued in effect without substantial change until January 1, 1933.

XIII. Instruction 10 of said System of Accounts provided:

"10. Costs to be actual money costs.—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. When the consideration actually given for anything with respect to which a charge is made to any fixed capital or other property account is anything other than money, the actual consideration should be described in the entry with sufficient fullness and particularity to identify it, and the amount

charged should be the actual money value of such consideration at the time of the transaction."

XIV. Instruction 13 of said System of Accounts provided:

"13. Plant and equipment and other property purchased.—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, 'Other Intangible Capital,' and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be distributed
186 through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts.

"Companies should be prepared to furnish the Commission, upon demand, a full report of the contract of acquisition, the consideration given therefor, the determination of the actual money value of such consideration if other than money, the appraisal, and the amounts charged to the respective accounts for each plant or other such fixed capital purchased. The purchaser is required to procure in connection with the acquisition of any such plant or other fixed capital all existing records, memoranda, and accounts in the possession or control of the grantor relating to the construction and improvement of such plant, and to preserve such records, memoranda, and accounts until authorized by law to destroy or otherwise dispose of them."

XV. Accounting Bulletin No. 11 adopted by the Interstate Commerce Commission on June 26, 1913, interpreting the provisions of said System of Accounts, Case No. 30, provided:

"Query.—What items should be classified as 'going or completed plant' under section 13, page 33, 'Plant and equipment and other property purchased' of the Uniform System of Accounts for Class A and B companies?

"Answer.—The term 'going or completed plant' is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—

(1) A telephone company as a whole,

(2) An entire central office,

(3) A system of lines and stations within a given area, or

(4) A complete section of toll plant.

"The purchase by one company from another of several poles and appurtenances, a switchboard, or other minor portions of plant shall be treated in the same manner as the purchase of materials and supplies; i. e., the purchasing company shall charge the fixed capital accounts at cost, as provided in section 10, page 33, of the Uniform System of Accounts for Class A and B companies."

XVI. Plaintiff, purporting to act under Instruction 13 and treating the acquisition of the toll plant as coming within the definition of "going or completed plant" contained in Case No. 30 in Bulletin No. 11, distributed the $5,973,441.47, which it
187 had paid for that property, among its various plant accounts in the precise amount of the appraised structural value of the various classes of plant purchased.

XVII. Plaintiff, purporting to act under Instruction 10 and treating the acquisition of the instruments as not coming within the definition of "going or completed plant" contained in Case No. 30 in Bulletin No. 11, recorded in its plant accounts the $6,661,238.91 which it had paid for the instruments.

XVIII. Effective January 1, 1933, the Interstate Commerce Commission issued a Revised System of Accounts which continued in force until January 1, 1937, the effective date of a System of Accounts for Telephone Companies prescribed by the defendant Commission. Such Revised System of Accounts did not require any change by the plaintiff in the accounting which it had performed with respect to the property which it had acquired from the American Company as described in Findings V to IX supra.

XIX. The Communications Act of 1934 (48 Stat. 1064, 47 U. S. C. A. §§ 151 et seq.) approved June 19, 1934, became effective upon the organization of the Commission on July 11, 1934, except as to Sections 1 and 4 thereof which became effective on July 1, 1934, and plaintiff was and is engaged in interstate and foreign communication by wire and radio within the meaning of Section 2 of that Act.

XX. On June 19, 1935, the defendant Commission issued telephone division order No. 7-C which prescribed for the plaintiff and other telephone companies, a system of accounts effective January 1, 1936, which differed from both systems theretofore prescribed by the Interstate Commerce Commission. Insofar as material to this proceeding this system of accounts prescribed, as to balance sheet accounts and investments, that account 100.1, "Telephone plant in service" should include the original cost (defined as meaning "the actual money cost of * * * property

188 at the time when it was first dedicated to the public use, whether by the accounting party or by predecessors"), of the company's property used in telephone service at the date of the balance sheet; that Account 100.4, "Telephone plant acquisitions adjustment," should include amounts representing the difference between (1) the amount of money actually paid for telephone plant acquired, plus expense of acquisition and (2) the original cost of such plant less the amount of reserve requirements for depreciation and amortization of the property acquired; and that the amounts recorded in Account 100.4 with respect to each property acquisition should be disposed of, written off, or provision should be made for the amortization thereof in such manner as the Commission might direct.

XXI. Upon the promulgation by the Commission of said proposed Uniform System of Accounts, plaintiff and a number of other telephone companies filed in this Court a complaint against the defendants herein in a suit entitled "American Telephone and Telegraph Company, et al., plaintiffs, against United States of America and Federal Communications Commission, defendants, In Equity No. 81-366" to enjoin, set aside, annul, and suspend the said proposed Uniform System of Accounts, and the effective date of said proposed Uniform System of Accounts was stayed pending said suit. In said suit plaintiffs claimed that the proposed Uniform System of Accounts would require them to write off a portion of their investment in telephone plant. Defendants denied that the definition of original cost would require the plaintiffs to restate as of January 1, 1936 (the effective date of the proposed System of Accounts) their property investment accounts by eliminating therefrom the recorded cost or investment of the plaintiff in property theretofore acquired from another public utility.

XXII. This Court in said suit made findings of fact, in part, as follows:

189 "III

"Telephone Division Order No. 7-C requires plaintiffs to include in the telephone plant accounts the 'original cost' of their telephone plant, and provides that the difference between said original cost and cost to the accounting company of property acquired from another utility shall be recorded on their books in other specified investment accounts.

"IV

"Plaintiffs have heretofore performed accounting with respect to property acquired from other public utilities which resulted in the inclusion in their telephone plant accounts of amounts repre-

senting various costs, such as current cost new, actual cost to plaintiffs, structural value, or cost to the predecessor company (by merger of book accounts). The Uniform System of Accounts prescribed by Telephone Division Order No. 7-C requires that in accounting for property acquired from another public utility, and in all other instances, plaintiffs' telephone plant accounts shall be stated on a uniform basis, that being 'original cost,' as therein defined.

"V

"Telephone Division Order No. 7-C does not require that the recorded cost or investment of the plaintiffs in property theretofore acquired by them from another public utility be obliterated or eliminated from their investment accounts, but merely requires plaintiffs to segregate the elements of recorded cost or investment into the following investment amounts:

100.1 Telephone plant in service.
100.2 Telephone plant under construction.
100.3 Property held for future telephone use.
100.4 Telephone plant acquisition adjustment.

"VI

"Telephone Division Order No. 7-C further requires plaintiffs to include in their investment accounts the amount which they actually pay for property acquired on and after January 1, 1936, from other public utilities.

"VII

"Telephone Division Order No. 7-C requires plaintiffs to segregate in an account numbered 100.4 and entitled 'Telephone plant acquisition adjustment,' the difference between (a) the amount of money which they actually paid for telephone plant acquired and (b) the original cost of such plant less the amounts of reserve requirements for depreciation and amortization of the property acquired and amounts of contributions to the predecessor company or companies for the construction and acquisition of such property.

190 "VIII

"The plaintiffs are not prevented by Telephone Division Order No. 7-C from recovering amounts included in Account 100.4 in view of the alternative provisions of paragraph (c) of the text of said Account 100.4, which make provision for the amortization or other appropriate disposition of amounts included in Account 100.4. The Commission had made no direction with respect to the disposition of any such amounts.

"IX

"Telephone Division Order No. 7-C requires that plaintiffs' accounts shall be kept on a basis which will reflect the facts with respect to their transactions and which will show their actual condition for the information of all persons interested therein, except with respect to contributions to predecessor utilities and depreciation of property held for future telephone use, and said order is capable of practical application except with respect to contributions to predecessor utilities.

"X

"Telephone Division Order No. 7-C does not prevent plaintiffs from recording in their expense accounts the expense of depreciation which they actually incur, except that said order does not provide for depreciation of the classes of depreciable property, the original cost of which is includible in Account 100.3. 'Property held for future telephone use.'

"XI

"Telephone Division Order No. 7-C does not require plaintiffs to write off any portion of their actual investment where they have paid a price in excess of original cost, but merely requires a segregation of this actual cost into certain investment accounts, all of which will appear in the balance sheet statements of plaintiffs; and no writing off is required by the provisions of Order No. 7-C when plaintiffs purchase property in the future, but only a segregation of such cost is required.

"XII

"Telephone Division Order No. 7-C does not require plaintiffs to make radical or retroactive changes in their completed accounts. In this respect said order merely requires the reclassification of balances as of its effective date in certain balance-sheet accounts.

"XIII

"Telephone Division Order No. 7-C does not require that amounts recorded in Account 100.4 be disposed of, written off, or amortized by plaintiffs. The form of the accounting to be performed is dependent upon the development of facts in connection with each individual acquisition. Said order merely provides for alternative modes of disposition adaptable to the facts of individual acquisitions."

191 This Court in said suit also made the following conclusion of law:

"XIII

"Telephone Division Order No. 7-C is not retroactive in its requirements."

XXIII. The plaintiffs in said suit appealed from the judgment of this Court to the Supreme Court of the United States. The Supreme Court, although affirming the judgment of this Court, in order "to avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed" required the defendants to file with it a memorandum embodying the interpretation of the proposed Uniform System of Accounts on which the defendants had relied in defending said suit, and the Supreme Court accepted this declaration as "an administrative construction binding upon the Commission in its future dealings with the companies." Said interpretation provided:

"(1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.

"(2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 186) or account 675 (R. 205).

"The Commission believes that the foregoing construction of its order is that which it presented to the District Court through the affidavits of its witnesses."

XXIV. After the decision of the Supreme Court, the defendant Commission entered an order making the new Uniform System of Accounts effective January 1, 1937, and said System of Accounts has remained in effect since that date without substantial modification.

XXV. From time to time after the acquisition of the toll
192 plant and instruments by the plaintiff as set forth in Findings V to IX supra, certain units of both have been retired and written out of the plant accounts at the amounts recorded therein, and the same amount less salvage has been charged to depreciation reserve. Out of the toll plant purchased by the plaintiff from the American Company at a cost of $5,973,441.27,

there remained in the plant accounts as of January 1, 1937, toll plant having an estimated book cost of $2,971,058.99, and as of January 1, 1942, toll plant having an estimated book cost of $2,611,586.39. Out of the instruments purchased by the plaintiff from the American Company at a cost of $6,661,238.91, there remained in the plant accounts as of January 1, 1937, instruments having an estimated book cost of $2,433,105.41, and as of January 1, 1942, instruments having an estimated book cost of $630,279.13.

XXVI. The accounting entries made by plaintiff with respect to the toll plant and instruments purchased by it from the American Company from the time of their acquisition until January 1, 1937, were made in conformity with the rules which had been prescribed by the Interstate Commerce Commission and which were in effect during that period.

Conclusions of law

I. This Court has jurisdiction to entertain this action by virtue of Section 402 (a) of the Communications Act of 1934 (48 Stat. 1064, 1093, 47 U. S. C. A. § 402 (a) and the Urgent Deficiencies Appropriations Act (38 Stat. 219, 28 U. S. C. A. §§ 41 (28), 46 and 48).

II. At the time of the acquisitions referred to in Findings of Fact V to IX supra, plaintiff was subject to the exclusive jurisdiction of the Interstate Commerce Commission with respect to its accounting and was prohibited from keeping any accounts other than those prescribed by that Commission, and plaintiff remained subject to the accounting rules which had been prescribed by said Interstate Commerce Commission until January 1, 1937, when the Uniform System of Accounts prescribed by the defendant Commission became effective.

193 III. The accounting entries made by the plaintiff with respect to the toll plant and instruments purchased by it from the American Company, from the time of their acquisition until January 1, 1937, were made in conformity with the rules which had been prescribed by the Interstate Commerce Commission and which were in effect during that period and were therefore the only lawful and correct entries to be made by the plaintiff.

IV. The defendant Commission has no power to apply retroactively a new system of accounts to write down the plaintiff's surplus with respect to entries which were lawfully and correctly made by the plaintiff under the Interstate Commerce Commission's prescribed System of Accounts.

V. The order described in Findings of Fact III sought to be enjoined in this proceeding attempts to apply retroactively the

Federal Communications Commission's System of Accounts to write down plaintiff's surplus with respect to entries made lawfully and correctly by the plaintiff under the Interstate Commerce Commission's prescribed System of Accounts.

VI. Under the stipulation of these defendants made in American Telephone and Telegraph Company, et al., against United States of America, et al., described in Findings of Fact XXIII, the defendant Commission cannot require the plaintiff to write off from its accounts amounts paid by it to another telephone company for property acquired by plaintiff from such other company in excess of the net book cost of the property to the vendor at the time of purchase, unless after a fair consideration of all circumstances, the Commission determines that such excess is not "a true increment of value" but is "a fictitious or paper increment."

VII. In making the order sought to be enjoined, the defendant Commission directed such a write off with respect to the
194 property purchased by the plaintiff from American Company, as set forth in Findings of Fact V to IX supra, without a fair consideration of all the circumstances and without any valid determination that such excess was not "a true increment of value," and such order therefore was made in violation of the stipulation referred to in Conclusion VI.

VIII. The determination that an amount paid by a telephone company for property to another telephone company in excess of the net book cost of such property to the vendor cannot be a true increment of value if the transaction was between affiliated companies, is arbitrary and therefore void and of no effect.

IX. The order sought to be enjoined is beyond the power of the Commission and is wholly illegal and void.

X. Said order should be permanently enjoined; set aside, suspended and annulled and the enforcement thereof permanently restrained and enjoined.

It is further ordered, that the Clerk of this Court be, and he hereby is, directed to enter final judgment, in form as approved by the Court, in favor of plaintiff for the relief demanded in the complaint.

Dated New York, N. Y., December 28, 1944.

(S) THOMAS W. SWAN,
U. S. Circuit Judge.

(S) JOHN W. CLANCY,
U. S. District Judge.

(S) JOHN BRIGHT,
U. S. District Judge.

[File endorsement omitted.]

195 In United States District Court

[Title omitted.]

Petition for a direct appeal to the Supreme Court of the United States

To The Hon. JOHN BRIGHT, District Judge for the Southern District of New York.

Now come the United States of America and the Federal Communications Commission, defendants herein, and feeling themselves aggrieved by the final order or decree of the District Court rendered and entered in the above-entitled cause on the 2nd day of January 1945, do hereby appeal therefrom to the Supreme Court of the United States because of errors prejudicial to defendants which are set forth in the assignment of errors presented and filed herewith, and pray that their appeal be allowed and that citation be issued as provided by law and that the record on appeal be made and certified and sent to the Supreme Court of the United States, in accordance with the rules of that Court.

CHARLES FAHY,
Solicitor General of the United States of America.
CHARLES R. DENNY,
General Counsel of the Federal Communications Commission.

Dated February 24, 1945.

196 In United States District Court

[Title omitted.]

Assignment of errors

Come now the United States of America and the Federal Communications Commission, defendants in the above-entitled cause, and file the following assignment of errors upon which they shall rely in the prosecution of the appeal to the Supreme Court of the United States herein petitioned for in said cause from the order, judgment and decree of the statutory three-judge District Court of the United States for the Southern District of New York entered on the 2nd day of January 1945.

(1) The Court erred in denying appellants' motion for summary judgment.

(2) The Court erred in issuing the injunction prayed for by appellee.

(3) The Court erred in its determination that the Federal Communications Commission was without power to promulgate the

order sought to be set aside by appellee, and in failing to hold that the Federal Communications Commission had authority to promulgate the said order.

(4) The Court erred in its determination that the action of the Commission in requiring the New York Telephone Company to write off from its accounts amounts paid by it to American Telephone and Telegraph Company for property acquired
197 from that company in excess of the net book cost of the property to that company at the time of the purchase did not constitute a fair consideration of all the circumstances and was not a valid determination that such excess was not a true increment of value within the meaning of the supplemental memorandum filed by the government in the case of American Telephone and Telegraph Company v. United States, 299 U. S. 232, and that the Commission's action was therefore in violation of the terms of that supplemental memorandum.

(5) The Court erred in its determination that the accounting entries here involved were made in compliance with then applicable rules and regulations of the Interstate Commerce Commission.

(6) The Court erred in its determination that the order of the Commission is invalid because it sought to apply retroactively the Federal Communications Commission's System of Accounts to write down appellee's surplus by requiring changes in certain accounting entries originally made by appellee in accordance with regulations of the Interstate Commerce Commission.

Wherefore, petitioners pray that the final order or decree entered herein on the 2nd day of January 1945, be reversed and that such other and further relief be granted as to the Court may seem just and proper.

CHARLES FAHY,
Solicitor General of the United States of America.
CHARLES R. DENNY,
General Counsel of the Federal Communications Commission.

Dated February 24, 1945.

198 In United States District Court

[Title omitted.]

Order allowing appeal

The defendants herein having filed a petition for appeal to the Supreme Court of the United States from the decree entered herein on January 2, 1945 and having filed their assignment of errors, it is,

Ordered, that an appeal by petitioners in the above-entitled cause to the Supreme Court of the United States from the decree heretofore filed and entered herein on January 2, 1945, be and the same is hereby allowed and that the record on appeal be made and certified and sent to the Supreme Court of the United States in accordance with the rules of that Court, said appeal being hereby made returnable forty (40) days from the date hereof.

Dated February 26, 1945.

(Sgd.) JOHN BRIGHT,
United States District Judge.

199 In United States District Court

[Title omitted.]

Notice of appeal

To The Honorable ATTORNEY GENERAL OF THE STATE OF NEW YORK; RALPH W. BROWN, Attorney for New York Telephone Company; FRANK A. FRITZ, Attorney for New York Telephone Company; HENRY J. FRIENDLY, Attorney for New York Telephone Company.

Pursuant to the Urgent Deficiencies Appropriation Act of October 22, 1913, Chap. 32, 38 Stat. 219, 220, you are hereby notified that the United States of America and the Federal Communications Commission, the above named defendants, have taken an appeal to the Supreme Court of the United States from the final decree of the specially constituted United States District Court entered herein January 2, 1945, denying the motion for summary judgment of said defendants and granting the relief sought by plaintiff in the suit by the New York Telephone Company to enjoin, set aside, annul, and suspend a certain order of the Federal Communications Commission designated Commission Order in Docket No. 6329, "In the Matter of the New York Telephone Company, Accounting," dated December 14, 1943, and the order allowing the said appeal makes the same returnable in the
200 Supreme Court of the United States forty (40) days from the date hereof.

Dated February 24, 1945.

CHARLES FAHY,
Solicitor General of the United States of America.
CHARLES R. DENNY,
General Counsel of the Federal Communications Commission.

201 In United States District Court

[Title omitted.]

Praecipe for transcript of record

To the Clerk of the United States District Court for the Southern District of New York:

You are hereby requested to make a transcript of record to be filed in the Supreme Court of the United States, pursuant to an appeal allowed in the above-entitled cause and to include in such transcript of record the following, and no other papers and exhibits, to wit:

1. Summons and Complaint, together with Exhibits A through G thereof.
2. Order convening three judge court.
3. Notice of Appearance of counsel for Federal Communications Commission.
4. Notice of Motion by United States and Federal Communications Commission for summary judgment and affidavit of Charles R. Denny annexed thereto [Exhibit A referred to therein should be transmitted as an original document—see item 16 of this praecipe.]
5. Motion to Intervene, and Notice thereof, of the Public Service Commission of the State of New York.
6. Order of the Court denying the motion of the Public Service Commission of the State of New York to Intervene.
7. Decision of the Court, dated August 24, 1944, denying the motion of the United States and the Federal Communications Commission for summary judgment.
8. Order and Judgment of the Court, entered January 2, 1945.
9. Petition for a Direct Appeal to the Supreme Court of the United States.
10. Assignment of Errors.
11. Statement as to Jurisdiction.

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12. Order Allowing Appeal.
13. Citation on Appeal.
14. Notice of Appeal.
15. Statement directing attention to Supreme Court Rule 12, para. 3.
16. Order Re Transmission of Original Documents.
17. Acceptance of Service of appeal papers.
18. Praecipe.

Said transcript to be prepared as required by law and the Rules of this Court, and the Rules of the Supreme Court of the United States, and is to be filed in the office of the Clerk of the Supreme Court.

Dated March 6, 1945.

CHARLES FAHY,
Solicitor General of the United States of America.
CHARLES R. DENNY,
General Counsel of the Federal Communications Commission.

Service of foregoing praecipe accepted and acknowledged this 8th day of March 1945.

HENRY J. FRIENDLY,
Attorney for New York Telephone Company.

203 In United States District Court

[Title omitted.]

Order re transmission of original documents

It is hereby directed that the original of Exhibit A to the affidavit of Charles R. Denny, filed March 29, 1944, be transmitted to the Supreme Court.

Dated February 24, 1945.

(Sgd.) JOHN BRIGHT.
United States District Judge,
United States District Court for the Southern District of New York.

Agreed to:

CHARLES FAHY,
Charles Fahy,
Solicitor General of the United States of America.
CHARLES R. DENNY,
Charles R. Denny,
General Counsel of the Federal Communications Commission
HENRY J. FRIENDLY,
Henry J. Friendly,
Counsel for Plaintiff.

204 [Citation in usual form filed Feb. 27, 1945, omitted in printing.]

204-A [Clerk's certificate to foregoing transcript omitted in printing.]

205 Supreme Court of the United States

Stipulation as to record

Filed April 19, 1945

Subject to the approval of this Court, it is hereby stipulated and agreed by and between the attorneys for the respective parties hereto that the administrative record before the Commission—Exhibit A to defendants' Motion for Summary Judgment—which consists of approximately 3,000 pages and 84 exhibits, need not be printed as part of the record and that any party may refer in the briefs to any portions thereof and may include in an appendix to the briefs such portions of the administrative record as are deemed relevant.

CHARLES FAHY,
Solicitor General of the United States of America.

HENRY J. FRIENDLY,
Counsel for Plaintiff.

Dated April 16, 1945.

206 Supreme Court of the United States

Statement of points to be relied upon and designation of the parts of the record to be printed

Filed April 19, 1945

Comes now the appellant in the above-entitled cause and states that the points upon which it intends to rely in this Court in this case are as follows:

(1) The Court erred in denying appellants' motion for summary judgment.

(2) The Court erred in issuing the injunction prayed for by appellee.

(3) The Court erred in its determination that the Federal Communications Commission was without power to promulgate the order sought to be set aside by appellee, and in failing to hold that the Federal Communications Commission had authority to promulgate the said order.

(4) The Court erred in its determination that the action of the Commission in requiring the New York Telephone Company to write off from its accounts amounts paid by it to American Telephone and Telegraph Company for property acquired from

that company in excess of the net book cost of the property to that company at the time of the purchase did not constitute a fair consideration of all the circumstnces and was not a valid determination that such excess was not a true increment of value within the meaning of the supplemental memorandum filed by the government in the case of American Telephone and
207 Telegraph Company v. United States, 299 U. S. 232, and that the Commission's action was therefore in violation of the terms of that supplemental memorandum.

(5) The Court erred in its determination that the accounting entries here involved were made in compliance with then applicable rules and regulations of the Interstate Commerce Commission.

(6) The Court erred in its determination that the order of the Commission is invalid because it sought to apply retroactively the Federal Communications Commission's System of Accounts to write down appellee's surplus by requiring changes in certain accounting entries originally made by appellee in accordance with regulations of the Interstate Commerce Commission.

And the appellant further states that only the following parts of the record, as filed in this Court, need be printed by the Clerk in the hearing of the case:

1. Summons and Complaint, together with Exhibits A through G thereof.
2. Order convening three-judge court.
3. Notice of Motion by United States and Federal Communications Commission for Summary judgment and affidavit of Charles R. Denny annexed thereto [excluding Exhibit A referred to therein transmitted to this Court as an original document].
4. Proposed Report of the Federal Communications Commission in Docket No. 6329, P–30, adopted June 22, 1943.
5. Exceptions of New York Telephone Company to said proposed Report.
6. Decision of the Court, dated August 24, 1944, denying the motion of the United States and the Federal Communications Commission for summary judgment.
7. Order and Judgment of the Court, entered January 2, 1945.
8. Petition for a Direct Appeal to the Supreme Court of the United States.
9. Assignment of Errors.
10. Statement as to Jurisdiction.
11. Order allowing Appeal.
12. Citation on Appeal.
13. Notice of Appeal.
14. Statement directing attention to Supreme Court Rule 12, paragraph 3.

15. Order Re Transmission of Original Documents.

16. Acceptance of Service of Appeal papers.

208 17. Praecipe.

18. Stipulation as to Record, dated April 16, 1945.

19. Statement of points to be relied upon and designation of the parts of the record to be printed.

CHARLES FAHY,
Solicitor General for the United States of America.

Service of the foregoing Statement of Points to be Relied upon and Designation of the Parts of the Record to be Printed is hereby acknowledged this 17th day of April 1945.

HENRY J. FRIENDLY,
Counsel for Appellee.

[File Endorsement Omitted.]

209 Supreme Court of the United States

Order noting probable jurisdiction

May 7, 1945

The statement of jurisdiction in this case having been submitted and considered by the Court, probable jurisdiction is noted and the case is transferred to the summary docket.

[Endorsement on cover:] File No. 49578. D. C. U. S., Southern New York. Term No. 1125. The United States of America and Federal Communications Commission, Appellants vs. New York Telephone Company. Filed April 7, 1945. Term No. 1125 O. T. 1944.

U. S. GOVERNMENT PRINTING OFFICE 1945

No. 1125

In the Supreme Court of the United States

October Term, 1944

The United States of America and Federal Communications Commission, appellants

v.

New York Telephone Company

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK

STATEMENT AS TO JURISDICTION

United States District Court, Southern District of New York

Civil Action 24-211

NEW YORK TELEPHONE COMPANY, PLAINTIFF

v.

UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, DEFENDANTS

STATEMENT AS TO JURISDICTION

This suit was instituted in the District Court of the United States for the Southern District of New York under the provisions of the Urgent Deficiencies Act as extended by Section 402 (a) of the Communications Act of 1934 (47 U. S. C. Section 402 (a)) to enjoin, set aside, annul and suspend an order of the Federal Communications Commission denominated Commission Order in Docket No. 6329 "In the Matter of the New York Telephone Company, Accounting," dated December 14, 1943, requiring the New York Telephone Company to make certain specified adjustments in its books of account in order to eliminate from its books certain write-ups in property values, presently reflected in the books of the company, found

640748—45——1

by the Commission to be purely fictitious write-ups resulting from transactions between a parent company and its controlled affiliate. Defendants filed a motion for summary judgment, together with the supporting affidavit of Charles R. Denny, and moved that the complaint of the New York Telephone Company be dismissed. The motion for summary judgment was argued before a three-judge district court convened pursuant to the provisions of the Urgent Deficiencies Appropriation Act of October 22, 1913, Chapter 32 (38 Stat. 220; 28 U. S. C. A. Section 47) and it was stipulated among the parties that final judgment might be entered as on a final hearing upon the decision of the Court with respect to the motion for summary judgment.

By decision, dated August 24, 1944, the Court denied the action for summary judgment and on January 2, 1945, a final judgment and order in the case were entered permanently enjoining, setting aside, suspending, and annulling the order of the Federal Communications Commission and permanently restraining and enjoining its enforcement.

Pursuant to Rule 12 of the Supreme Court of the United States, the petitioner, in support of the jurisdiction of the Supreme Court to review the judgment, order, and decree in question, respectfully represents:

I

STATUTORY PROVISIONS BELIEVED TO SUSTAIN JURISDICTION

The statutory provisions believed to sustain the jurisdiction of this appeal are:

Section 402 (a) of the Communications Act of 1934, 47 U. S. C. Sec. 402 (a), which makes the provisions of the Urgent Deficiencies Act applicable to this suit; and

The Urgent Deficiencies Act of October 22, 1913, c. 32; 38 Stat. 219, 220; 28 U. S. C. Secs. 47, 47a, which provides for direct appeal to the Supreme Court of the United States from judgments or decrees of three-judge courts constituted under the Act.

II

STATUTE OF THE UNITED STATES AND ORDER PROMULGATED THEREUNDER, THE VALIDITY OF WHICH IS INVOLVED

The pertinent provisions of the Communications Act of 1934 are:

> SEC. 213. (c) The Commission may at any time require any such carrier to file with the Commission a statement showing the original cost at the time of dedication to the public use of all or of any part of the property owned or used by said carrier. For the showing of such original cost said property shall be classified, and the original cost shall be defined, in such manner as the Commission may prescribe; and if any

part of such cost cannot be determined from accounting or other records, the portion of the property for which such cost cannot be determined shall be reported to the Commission; and, if the Commission shall so direct, the original cost thereof shall be estimated in such manner as the Commission may prescribe. If the carrier owning the property at the time such original cost is reported shall have paid more or less than the original cost to acquire the same, the amount of such cost of acquisition, and any facts which the Commission may require in connection therewith, shall be reported with such original cost. The report made by a carrier under this paragraph shall show the source or sources from which the original cost reported was obtained, and such other information as to the manner in which the report was prepared, as the Commission shall require.

Sec. 220. (a). The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys.

Sec. 220. (c) The Commission shall at all times have access to and the right of inspection and examination of all accounts, records, and memoranda, including all documents, papers, and correspondence now or

hereafter existing, and kept or required to be kept by such carriers, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by such person. Any provision of law prohibiting the disclosure of the contents of messages or communications shall not be deemed to prohibit the disclosure of any matter in accordance with the provisions of this section.

Sec. 220. (g) After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect.

Sec. 402. (a) The provisions of the Act of October 22, 1913 (38 Stat. 219), relating to the enforcing or setting aside of the or-

ders of the Interstate Commerce Commission, are hereby made applicable to suits to enforce, enjoin, set aside, annul, or suspend any order of the Commission under this Act (except any order of the Commission granting or refusing an application for a construction permit for a radio station, or for a radio station license, or for renewal of an existing radio station license, or for modification of an existing radio station license, or suspending a radio operator's license) and such suits are hereby authorized to be brought as provided in that Act.

SEC. 604. (a) All orders, determinations, rules, regulations, permits, contracts, licenses, and privileges which have been issued, made, or granted by the Interstate Commerce Commission, the Federal Radio Commission, or the Postmaster General, under any provision of law repealed or amended by this Act or in the exercise of duties, powers, or functions transferred to the Commission by this Act, and which are in effect at the time this section takes effect, shall continue in effect until modified, terminated, superseded, or repealed by the Commission or by operation of law.

The Federal Communications Commission, purporting to act under the authority of the Communications Act of 1934, ch. 652, 46 Stat. 1064, as amended, 47 U. S. C. Secs. 151-609, made the order hereinafter set forth.

BEFORE THE FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D. C.

Docket No. 6329
P-30

IN THE MATTER OF NEW YORK TELEPHONE COMPANY, ACCOUNTING

ORDER

At a session of the Federal Communications Commission held at its offices in Washington, D. C., on the 14th day of December, 1943;

The Commission, having under consideration the record of the proceedings herein, including its Proposed Report herein adopted June 22, 1943, the exceptions and arguments with respect thereto; and having this day adopted its Report herein;

IT IS ORDERED, That the Report of the Commission adopted this day in this proceeding BE, AND IT IS HEREBY MADE A PART HEREOF BY REFERENCE:

IT IS FURTHER ORDERED, That:

(1) The New York Telephone Company shall charge (debit) the amount of $4,166,-510.57 to its Account 413, "Miscellaneous Debits to Surplus";

(2) The New York Telephone Company shall concurrently with such charge to Account 413, make entries (a) to eliminate, by appropriate entries to its Account 100.4,

"Telephone Plant Acquisition Adjustment", the amounts presently included in that account, associated with the New York Telephone Company's acquisition from the American Telephone and Telegraph Company on November 1, 1925, September 1, 1926, and December 31, 1928; (b) to eliminate the Amounts presently included in Account 172, "Amortization Reserve", associated with such acquisitions, with contra entries to Account 171, "Depreciation Reserve"; (c) to adjust the balances in Account 100.1, "Telephone Plant in Service", and the related primary plant Account 231, "Station Apparatus", to reflect the original cost of the surviving telephone instruments acquired by the New York Telephone Company from the American Telephone and Telegraph Company on December 31, 1927, by debits to those accounts in the amount of the difference between such original cost and the surviving amounts recorded in such accounts; and (d) to adjust the balance in Account 171, to reflect appropriately the elimination of the inter-company profit or write-up of $4,166,510.57 resulting from the accounting performed by the New York Telephone Company at the time of and during the period since such acquisition, with respect to and as a result of such acquisitions, by credits to that account equal to the difference between the amounts debited to Account 100.1 and Account 413, and the amounts credited to Account 100.4;

(3) The New York Telephone Company shall correct its books and records as of December 31, 1941, by placing thereon the following entries:

Entry No. 1		Debit	Credit
100.1	Telephone Plant in Service (Account 231, Station Apparatus)	$194, 886. 97	
100.4	Telephone Plant Acquisition Adjustment		$481, 439. 80
171	Depreciation Reserve		3, 879, 957. 94
413	Miscellaneous Debits to Surplus	4, 166, 510. 57	

This entry made in accordance with the order of the Federal Communications Commission dated December 14, 1943, in Docket No. 6329.

Entry No. 2		Debit	Credit
171	Depreciation Reserve		$333, 559. 21
172	Amortization Reserve	$ 333, 559. 21	

This entry made in accordance with the order of the Federal Communications Commission dated December 14, 1943, in Docket No. 6329.

(4) The New York Telephone Company shall make any necessary entries to adjust entries reflecting transactions subsequent to December 31, 1941, and to adjust between Account 231, "Station apparatus," and Account 122, "Material and Supplies," as may be required to be consistent with the entries required by the above provisions of this order.

(5) All charges which the New York Telephone Company has made to its operating expense accounts for the purpose of, or in conjunction with, amortizing or otherwise disposing of all amounts included in,

its Account 100:4 other than those included therein with respect to the toll property acquisitions dated November 1, 1925, September 1, 1926, and December 31, 1928, shall continue to be suspended, and respondent shall cause and desist from making any such charge to its operating expense accounts, pending submission of proof by respondent of the propriety and reasonableness of such charges, and the specific direction, authorization, or approval of the Commission:

IT IS FURTHER ORDERED, That the investigation instituted by the Commission's order of June 16, 1942, herein, to determine whether respondent or any of its officers or directors has violated certain of the Commission's accounting rules and regulations BE, AND IT IS HEREBY TERMINATED AND DISMISSED;

IT IS FURTHER ORDERED, That the New York Telephone Company shall within 60 days from the service of this order submit verified proof that the journal entries required herein have been made.

IT IS FURTHER ORDERED, That the New York Telephone Company shall within 40 days from the service of this order notify this Commission in writing whether this order and all of its terms and requirements are accepted and will be obeyed.

By the Commission,

(Sgd.) T. J. SLOWIE,
T. J. Slowie,
Secretary.

III

DATE OF JUDGMENT OR DECREE AND DATE OF APPLICATION FOR APPEAL

The date of the decree sought to be reviewed is January 2, 1945, on which day the said decree was made and entered.

The application for this appeal was made on February —, 1945.

IV

NATURE OF THE CASE

In 1925, 1926, and 1928, American Telephone and Telegraph Company transferred to plaintiff, New York Telephone Company, which the American Telephone and Telegraph Company controlled through ownership of 100 percent of its common stock, certain toll line properties, and in 1927 it also transferred to plaintiff certain parts of the telephone instruments theretofore owned by American Telephone and Telegraph Company. The transfers did not involve any change in the physical character of the property, in the service rendered to the public, or the use of the plant in rendering the service. Before the transfers the property was carried on the books of American Telephone and Telegraph Company at $13,269,-567.47 with related depreciation and amortization reserves of $4,801,397.66, or a net book cost of $8,468,169.81. The "prices" assigned to the properties for the purpose of the transfer totaled

$12,634,680.38, or a "profit" to American Telephone and Telegraph Company of $4,166,510.57. The price was allegedly equal to or less than the estimated reproduction cost new of the property at that time less existing depreciation.

Plaintiff recorded the transfers on its books by entering in its plant accounts the "prices" assigned to each transfer, which were thus the "book cost" to it. No amount was entered with respect to this property in its depreciation or amortization reserve accounts. Thereafter, there was credited annually to the depreciation reserve a certain percentage of the "book cost" of the property as so recorded on plaintiff's books. This percentage was the depreciation rate which had theretofore been determined (as revised from time to time) to be applicable to the several classes of telephone plant accounts in which the transfers in question were recorded.

From time to time some of the transferred property was retired by the plaintiff. This was accomplished by crediting the plant accounts with the entire book cost to plaintiff of such property and by debiting the same amounts (with allowance for salvage) to its depreciation or amortization reserve accounts.

In July 1934 jurisdiction with respect to plaintiff's accounting was transferred from the Interstate Commerce Commission to the Federal Communications Commission. On January 1, 1937 fol-

lowing the decision of the Supreme Court in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232, the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies became effective and its provisions are applicable to plaintiff as a Class A telephone company. By the provisions of this Uniform System of Accounts plaintiff was required to reclassify the amounts recorded in its existing accounts to conform with the original cost provisions of the Commission's Uniform System of Accounts. In purported compliance plaintiff transferred a small amount, as pertaining to certain of the above transfers of property, from Account 100.1, "Telephone plant in service" to Account 100.4, "Telephone plant acquisition adjustment." In this process of reclassification, no amount was credited to Account 171, "Depreciation reserve."

In June 1942 the Commission instituted an investigation into the accounting performed and the accounts, records, and memoranda kept by plaintiff with respect to the transfers in question. Plaintiff was ordered to show cause why the amount of $4,166,510.57 should not be charged to Account 413, "Miscellaneous debits to surplus." After public hearings and argument, the Commission on December 14, 1943, issued its report and order. The Commission found that the accounting performed by the plaintiff with respect to the

four inter-company transfers resulted in a purely inflationary write-up of plaintiff's accounts. The Commission further found that such inflationary write-up was still present in plaintiff's accounts despite the physical retirement of some of the property. As to the surviving property the inflation was either in the plant or depreciation reserve accounts; as to the retired property the inflation was present in the form of a deficiency in the depreciation reserve account. Accordingly, the Commission directed plaintiff to charge the entire amount of $4,166,510.57 to surplus with appropriate concurrent entries.

On February 11, 1944, New York Telephone Company, pursuant to the provisions of the Urgent Deficiencies Act as extended by section 402 (a) of the Communications Act (47 U. S. C. sec. 402 (a)), filed a suit in the United States District Court for the Southern District of New York against the United States and the Federal Communications Commission to enjoin, set aside, annul, or suspend the Commission's order of December 14, 1943. On March 29, 1944, the United States and the Federal Communications Commission filed a motion for summary judgment together with the supporting affidavit of Charles R. Denny. In accordance with the procedure approved by the Supreme Court in *National Broadcasting Company, Inc.* v. *United States*, 319 U. S. 190, the record of the proceedings before the Commission

was attached to the affidavit and made a part thereof. It was stipulated among the parties that upon determination of the motion, final judgment might be entered as on a final hearing in favor of the party in whose favor the motion should be decided.

On August 24, 1944, the Court handed down its opinion denying the motion for summary judgment and on January 2, 1945, entered a final judgment and order permanently enjoining, setting aside, suspending, and annulling the order of the Commission. The Court held that the Commission's order violated the supplemental memorandum filed by the Government in *United States* v. *American Telephone & Telegraph Co.*, 299 U. S. 232. The court further held that the Commission's order was invalid because the accounting performed by the New York Telephone Company in connection with the transfers in question was in complete accord with the applicable rules and regulations of the Interstate Commerce Commission, and that since the entries were correct when made the Commission could not retroactively apply a new system to write down the plaintiff's surplus.

V

SUBSTANTIAL NATURE OF THE QUESTIONS INVOLVED

The questions raised upon this appeal are substantial:

(1) *The Supplemental Memorandum in the American Telephone and Telegraph case.*—The court in the instant case held that the order of the Commission violates the supplemental memorandum filed in *American Telephone and Telegraph Company v. United States*, 299 U. S. 232. This constitutes a serious misconstruction of both that supplemental memorandum and the opinion of this Court in that case. The supplemental memorandum and the opinion of the Court in the *American Telephone and Telegraph Company* case clearly recognize the right of the Commission to require carriers to write off their books as fictitious or paper increments the difference between original cost and so-called price resulting from transactions between a parent company and its controlled subsidiary.

(2) *Applicability of Accounting Regulation of the Interstate Commerce Commission.*—The court in the instant case held that the accounting performed by plaintiff was in complete accord with the rules of the Interstate Commerce Commission applicable when the transfers were made and that the Federal Communications Commission could not retroactively apply a new system. This over-

looks the provisions of Section 604 (a) of the Communications Act (47 U. S. C. Sec. 604 (a)) which specifically authorizes the Federal Communications Commission to modify, terminate, supersede or repeal rules or regulations of the Interstate Commerce Commission. This the Commission did when it adopted its Uniform System of Accounts. Upon the adoption of this system of accounts the Commission did not attempt to impose a penalty on plaintiff for its failure to keep its books in the past in accordance with the Federal Communications Commission's Uniform System of Accounts. What the Commission did was to require plaintiff to reclassify its accounts so that they would accurately reflect existing facts according to the Federal Communications Commission's System of Accounts. This requirement would apply not only to property which survived but also—and even plaintiff conceded this in its brief in the court below—as to retired property if the accounting performed with respect to the property in question had caused the balance in some other account not to conform to the facts. The question thus reduces itself to the simple question whether the accounting performed with respect to the retired property did result in a misstatement still reflected in some of the accounts when the Commission assumed jurisdiction.

The record is clear that there was such a misstatement. The depreciation of the property

which plaintiff acquired from A. T. & T. was accounted for by the plaintiff at annual rates which did not take into consideration the fact that the property was partly depreciated at the time of its acquisition, and was entered on its books at a figure which purported to reflect existing depreciation, with nothing being included in the depreciation or amortization reserves with respect to the property. As a result, when the property reached the end of its service life insufficient amounts had been accumulated in plaintiff's depreciation reserve to cover the cost of the property as carried in plaintiff's plant accounts. Thus, when the property in question was retired and plaintiff's book cost of the property was credited to plant account and the same amount was debited to depreciation reserve, plaintiff charged to the depreciation reserve more than had been credited thereto; the excess being at least as much as the amount of the write-up with respect to that property. This resulted in moving the inflation from the plant accounts to the depreciation reserve in the form of a deficiency in the reserve. Under this type of accounting the retirement of property could not possibly have removed any of the inflation which was introduced into the accounts when the transfers took place.

Plaintiff argued before the Commission and the court below that its depreciation reserve as a

whole has not been shown to be inadequate. Plaintiff's point seems to be that the mere fact that it debited its depreciation reserve with more than it had credited thereto is not controlling unless it can be shown that the depreciation reserve as a whole is inadequate. This is certainly a novel doctrine. What plaintiff is urging is that when the Commission discovers that there is inflation in plaintiff's accounts because of excessive debits in its depreciation reserve, the Commission is powerless to require plaintiff to eliminate this inflation unless the Commission can find that the depreciation reserve as a whole is inadequate. The composition of the depreciation reserve of a company whose operations are as extensive as those of plaintiff depends upon many complex and variable factors. If, as plaintiff suggests, the Commission may correct accounting mistakes which it finds with respect to that depreciation reserve only after it examines or reexamines anew in every case the overall adequacy of the depreciation reserve, the Commission would be hamstrung in the effective exercise of its accounting power. Under plaintiff's theory, there would be nothing to prevent it from increasing its own surplus or from making appropriations for payment into the surplus of its parent company, merely by debiting depreciation reserve—all this without any control by the Commission unless the Commission could find that such action left the

depreciation reserve as a whole impaired. This would make a mockery of regulatory accounting.

VI

DECISIONS BELIEVED TO SUSTAIN JURISDICTION

National Broadcasting Company et al. v. *United States*, 316 U. S. 447.

Columbia Broadcasting System, Inc. v. *United States*, 316 U. S. 407.

American Telephone & Telegraph Co. v. *United States*, 299 U. S. 232.

It is respectfully submitted that the Supreme Court of the United States has jurisdiction of this appeal and that the questions presented are substantial.

A copy of the opinion delivered by the District Court denying the motion for summary judgment and which is sought to be reviewed, together with the order of the court containing the findings of fact and the decree of the Court is attached to this statement as Exhibit A.

Respectfully submitted.

CHARLES FAHY,
Charles Fahy,
Solicitor General of the United States of America.
CHARLES R. DENNY,
Charles R. Denny,
General Counsel of the Federal Communications Commission.

Dated FEBRUARY 24, 1945.

United States District Court, Southern District of New York

Civ. 24-211

NEW YORK TELEPHONE COMPANY, PLAINTIFF

v.

UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, DEFENDANTS

Before THOMAS W. SWAN, Circuit Judge, and JOHN W. CLANCY and JOHN BRIGHT, District Judges

Ralph W. Brown, Esq., 140 West Street, New York City; *Frank A. Fritz, Esq.*, 140 West Street, New York City; *Henry J. Friendly, Esq.*, 31 Nassau Street, New York City; attorneys for New York Telephone Company.

Honorable *James B. M. McNally*, United States Attorney for the Southern District of New York, attorney for the United States of America.

Charles R. Denny, Esq., General Counsel, Federal Communications Commission, New Post Office Bldg., Washington, D. C.

BRIGHT, D. J.: Defendants move for summary judgment on the ground that there is no genuine issue of fact. Plaintiff asks, at this time, no affirmative relief.

Jurisdiction is not questioned, and is established by Section 402 (a) of the Commissions Act of 1934, 48 Stat. 1064, 1093, 47 U. S. C. A. Section 402 (a), and by the Urgent Deficiencies Appropriation Act, 38 Stat. 219, 28 U. S. C. A. Section 41 (28) and Sections 46 and 48.

The action is brought to enjoin and annul an order of the Federal Communications Commission dated December 14, 1943, which directed plaintiff to make certain accounting changes in its books, by reducing its surplus by $4,166,510.57 (the excess of payments by plaintiff to American Telephone & Telegraph Company, which we will call the "American Company," for telephone plant purchased by plaintiff from the latter on November 1, 1925, September 1, 1926, and December 31, 1928, and for telephone instruments so acquired on December 31, 1927) over the amount found by the Commission to represent the net book cost of such acquisitions on the books of the American at the time of such purchase; to restate this investment in plant so acquired; to balance these changes by adding to depreciation reserve $3,879,957.94; and to make other entries in its accounts.

At the time of these acquisitions, the American Company owned all of the outstanding common stock of the plaintiff. There were also outstanding in the hands of the public 250,000 shares of plaintiff's 6½% $100 cumulative preferred stock, and in excess of $132,000,000 of mortgage bonds. All

of plaintiff's officers, and at least two-thirds of its directors, were not directors, officers or employees of the American Company. It maintained its own books and records, and its employees, property and business were separate and apart from those of the American Company.

Prior to 1925 the American Company had furnished intrastate and interstate toll service between certain points in New York. In that year it was agreed that such business would be transferred to plaintiff. In order to accomplish that, plaintiff purchased from the American Company certain toll plant, consisting of tangible property such as poles, wires, serials and underground cable rights of way, etc., as of November 1, 1925, September 1, 1926, and December 31, 1928.

Prior to December 31, 1927, the American Company, as holder of the fundamental Bell patents, owned three small but essential parts of the telephone equipment placed with subscribers by plaintiff. These parts were the transmitter, receiver and an induction coil, and were commonly known as the instruments. On that date the American Company sold to plaintiff the instruments then in service or in the supplies of plaintiff, at a price based upon then average price charged the American Company by Western Electric Company, the manufacturer of the instruments, less an allowance of 20% to reflect the condition of the instruments.

The purchase price for the toll plant was agreed upon as being an amount equal to the cost of

reproduction less deterioration, determined by a field inspection and detailed appraisal; and that of the instruments was approved by qualified engineers of the plaintiff. A tabulation of these purchases as compared with the book cost to the American Company shows:

Total plant	Purchase price	American book cost	American depreciation reserve	American net book cost	Cost of purchase price over net book cost
11/1/25	5,831,884.78	5,010,340.19	801,858.95	4,208,481.24	1,623,403.54
9/1/26	97,310.39	95,924.66	14,449.20	81,475.46	15,834.93
12/31/28	44,246.30	28,077.64	4,144.78	23,932.86	20,313.44
	5,973,441.47	5,134,342.49	820,452.93	4,313,889.56	1,659,551.91
Instruments					
12/31/27	6,661,238.91	8,135,224.98	3,980,944.73	4,154,280.25	2,506,958.66
	12,634,680.38	13,269,567.47	4,801,397.66	8,468,169.81	4,166,510.57

At the time of these transactions, plaintiff was a telephone company within the meaning of the Interstate Commerce Act and subject to Section 20 of that Act (24 Stat. 379, 386 as amended by 34 Stat. 584, 598, 594), and was prohibited by that section from keeping any other accounts than those prescribed by the Interstate Commerce Commission. That Commission, on December 10, 1912, prescribed a uniform system of accounts for telephone companies, and that system, as interpreted by the Interstate Commerce Commission, by Instruction 10, provided:

> 10. *Costs to be actual money costs.*—All charges made to fixed capital or other property accounts with respect to any property

acquired on or after January 1, 1913, should be the actual money costs of the property. * * *

Instruction 13 of that system provided, in part:

13. *Plant and equipment and other property purchased.*—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204. Other Intangible Capital, "and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts. * * *

The accounting bulletin adopted by the Interstate Commerce Commission on June 26, 1916, provided in case No. 30:

> *Query.* What items should be classified as "going or completed plant" under section 13, page 33, "Plant and equipment and other property purchased" of the Uniform System of Accounts for Class A and B companies?
>
> *Answer.* The term "going or completed plant" is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—
>
> (1) A telephone company as a whole.
>
> (2) An entire central office.
>
> (3) A system of lines and stations within a given area, or
>
> (4) A complete section of toll plant.
>
> The purchase by one company from another of several poles and appurtenances, a switchboard, or other minor portions of plant shall be treated in the same manner as the purchase of materials and supplies; i. e., the purchasing company shall charge the fixed capital accounts at cost, as provided in section 10, page 33, of the Uniform System of Accounts for Class A and B companies.

Plaintiff, purporting to act under Instruction 13, and treating the acquisition of the plant as coming within case No. 30, distributed the $5,973,441.47, which it claimed was the actual cost to it of that property, among its various plant accounts

in the precise amount of appraised structural value of the various types of property purchased; and purporting to act under Instruction 10, recorded the $6,661,238.91, which it claimed to have paid for the instruments, in the plant accounts.

The Interstate Commerce Commission's system of accounts continued in effect until January 1, 1933, on which date a revised system became effective, which continued in force until January 1, 1937, the effective date of the uniform system of accounts for telephone companies prescribed by the defendant Federal Communications Commission. The revision of the system by the Interstate Commerce Commission as of January 1, 1933, did not require any change by the plaintiff in the accounting which it had performed with respect to the transactions in question.

The Communications Act of 1934 (48 Stat. 1064, 47 U. S. C. A. Sections 51 et seq.) approved June 19, 1934, became effective upon the organization of the Commission on July 11, 1934, except as to Sections 1 and 4 thereof, which became effective on July 1, 1934; and plaintiff was and is engaged in interstate and foreign communication by wire and radio within the meaning of Section 2 of that Act.

Under that Act, the defendant, Federal Communications Commission, is given power to "Make such rules and regulations, and issue such orders, not inconsistent with this Act, as may be neces-

sary in the execution of its functions," § 4 (1); to "At any time require any such carrier (which, by definition in 3 (h) would include this plaintiff) to file with the Commission a statement showing the original cost at the time of dedication to the public use of all or any part of the property owned or used by said carrier. * * * If the carrier owning the property at the time such original cost is reported shall have paid more or less than the original cost to acquire the same, the amount of such cost of acquisition, and any facts which the Commission may require in connection therewith, shall be reported with such original cost," § 213 (e); to prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act," § 220 (a), and under subdivision (c) of the same section, the "burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by any such person." And under subdivision (g), "After the Commission has prescribed the form and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records or memoranda than those so prescribed or such as may be approved by the Commission to to keep the accounts

in any other manner than that prescribed or approved by the Commission.

By Section 604 (a), "All orders, determinations, rules, regulations, * * * which have been issued, made or granted by the Interstate Commerce Commission * * * under any provision of law repealed or amended by this Act, or in the exercise of duties, powers or functions transferred to the Commission by this Act, and which are in effect at the time this Section takes effect, shall continue in effect until modified, terminated, superseded or repealed by the Commission or by operation of law."

On June 19, 1935, the defendant Commission issued telephone division order No. 7-G, which prescribed for the plaintiff and other telephone companies, a system of accounts effective January 1, 1936, which differed from both systems theretofore prescribed by the Interstate Commerce Commission. Insofar as we are now interested, this system of accounts prescribed, as to balance sheet accounts and investments, that account 100.1, "Telephone plant in service" shall include the original cost (defined in § 31.01-3 (k) as meaning "the actual money cost of * * * property at the time when it was first dedicated to the public use, whether by the accounting party or by predecessors"), of the company's property used in telephone service at the date of the balance sheet; and Account 100.4, "Telephone plant ac-

quisitions adjustment," should include amounts determined in accordance with § 31.2-21 representing the difference between (1) the amount of money actually paid for telephone plant acquired, plus expense of acquisition and (2) the original cost of such plant less the amount of reserve requirements for depreciation and amortization of the property acquired. "(c) The amounts recorded in this Section with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct." Section 21.2-21 relating to telephone plant acquired provided that when substantially complete toll line was acquired from predecessors, and charged to account 276, "Telephone plant acquired," the accounting shall be completed as follows: The original cost shall be charged to the telephone plant accounts as appropriate and credited to Account 276; the reserve requirements for depreciation and amortization shall be credited to Account 171 "depreciation reserve," and Account 172 "amortization reserve," and debited to Account 276; and the amount remaining in Account 276 shall be debited or credited as appropriate to Account 100.4 "Telephone plant acquisition adjustment," with certain exceptions not important here.

The promulgation of this system of accounts was met by an action in which the American Com-

pany and other telephone companies, including this plaintiff, were plaintiffs, and the United States and Federal Communications Commission were defendants, to enjoin and annul the proposed system. The plaintiffs were almost completely unsuccessful in this court (14 F. Supp. 121), and upon appeal, the Supreme Court affirmed, 292 U. S. 232. In this court, the defendants denied that the definition of original cost would require the plaintiffs to restate as of January 1, 1936, their property investment accounts by eliminating therefrom the recorded cost or investment of the plaintiff in property theretofore acquired from another public utility.

The Statutory Court made findings of fact, in part, as follows: V, that the order 7-C does not require that the recorded cost or investment in plaintiff's property theretofore acquired from another public utility be obliterated or eliminated from their investment accounts, but merely requires the plaintiffs to segregate the element of recorded cost or investment into investment accounts 100.1-2-3-4; VIII, that the order does not prevent plaintiffs from recovering amounts included in accounts 100.4 in view of the alternative provisions in paragraph C, and the Commission has made no direction in paragraph C, and the Commission has made no direction with respect to the disposition of any such accounts; XI, that the order does not require plaintiffs to write off

any portion of their actual investment where they had paid in excess of the original cost; XII, does not require plaintiffs to make radical or retroactive changes in their completed accounts, but merely requires the reclassification of balances as of its effective date in certain balance sheet accounts; and XIII, it does not require that amounts recorded in account 100.4 be disposed of, written off, or amortized by plaintiffs, the form of accounting to be performed is dependent upon the development of facts in connection with each individual acquisition. And in the 13th conclusion of law, the lower court found that the order was not retroactive in its requirements.

In the Supreme Court, Mr. Justice Cardozo wrote in part:

> The argument is that account 100.4 representing the difference between original and present cost, is not to be reckoned, either wholly or in part, as a statement of existing assets, but must be written off completely. The Commission is charged, we are told, with a mandatory duty to extinguish the entire balance recorded in that account, its presence under the title of "investments" having the effect of a misleading label. To give support to that conception of official duty, they rely on subdivision (c), which provides, as we have seen, that "the amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or

provision shall be made for the amortization thereof in such manner as this Commission may direct."

If subdivision (c) had the meaning thus imputed to it, there would be force in the contention that the effect of the order is to distort in an arbitrary fashion the value of the assets. But the imputed meaning is not the true one. The Commission is not under a duty to write off the whole or any part of the balance in 100.4, if the difference between original and present *cost is a true increment* of value. On the contrary, only such amount will be written off as appears, upon an application for appropriate directions, to be a fictitious or paper increment. This is made clear, if it might otherwise be doubtful, by administrative construction. * * *

To avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed, we requested the Assistant Attorney General to reduce his statements in that regard to writing in behalf of the Commission. He did this and informs us that "the Federal Communications Commission construes the provisions of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4" as meaning "that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets

of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization."

We accept this declaration as an administrative construction binding upon the Commission in its future dealings with the companies. * * * The administrative construction now affixed to the contested order devitalizes the objection that the difference between present value and original cost is withdrawn from recognition as a legitimate investment.

We are not impressed by the argument that the classification is to be viewed as arbitrary because the fate of any item, its ultimate disposition, remains in some degree uncertain until the Commission has given particular directions with reference thereto. By being included in the adjustment account, it is classified as provisionally a true investment, subject to be taken out of that account and given a different character if investigation by the Commission shows it to be deserving of that treatment. Such a reservation does not amount to a departure from the statutory power to fix the forms of accounts for "classes" of carriers rather than for individuals. The forms of the accounts *are* fixed, and fixed by regulations of adequate generality. What disposition of their content may afterwards be suitable upon discovery that particular items have

> been carried at an excessive figure must depend upon *evidentiary circumstances,* difficult to define or catalogue in advance of the event. If once there was any need for explanation more precise than that afforded by the order, it is now supplied, we think, by an administrative construction, which must be read into the order as supplementary thereto.'

It is to be observed that this case did not decide what power the Commission had other than to order a uniform system of accounts. The order 7-C was clearly found to be within the law as a constitutional and statutory exercise of the powers conferred upon the Commission by the Communications Act of 1934. While appellants in that case complained that the system of accounting might authorize the Commission in the future to do something toward obliterating or striking out the difference between original cost and purchase price, the court refused to adjudicate as to the validity of the system based upon any such anticipated action. It left the determination of that point to be decided upon whatever facts might subsequently be revealed as justifying it. It would seem that the only question here is whether the Commission now has power to direct the debit to surplus and the other charges of which complaint is now made. The other case stopped short of deciding that.

From time to time after the acquisition of the toll plant and instruments, certain units of both

have been retired and written out of the plant accounts at the amounts recorded therein and the same amount less salvage has been charged to depreciation reserve. Out of the total plant purchased at a cost of $5,973,441.27, there remained in the plant accounts as of Jan. 1, 1937, toll plant of an estimated book cost of $2,971,058.99, and as of Jan. 1, 1942, an estimated book cost of $2,611,586.39. Out of the instruments purchased at a cost of $6,661,238.91, there remained in the plant accounts as of Jan. 1, 1937, instruments having an estimated book cost of $2,433,105.41, and as of Jan. 1, 1942, an estimated book cost of $630,279.13.

Here the accounting practice followed by the plaintiff, at the time of and for a number of years after the acquisition of the toll plant and instruments, was, in our opinion, in conformity with the rules of the Interstate Commerce Commission. Testimony that it did not follow good accounting practice would be immaterial if the practice followed was within the regulations then in force.

When the "original cost" theory was introduced by the Communications Act of 1934, insofar as telephone companies were concerned, a new system of accounting was devised by the Federal Communications Commission which required for the first time the segregation of the so-called "profit" into an account other than that in which original cost was entered. At that time some portion of

the toll plant and instruments had been retired. The right to make the segregation was attacked in the A. T. & T. case, one of the reasons given being that because segregation was required, the difference between original cost and the alleged price "must be written off completely * * * the Commission is charged * * * with the mandatory duty to extinguish the entire balance recorded in" account 100.4 pursuant to subdivision (C) of that accounting requirement. Mr. Justice Cardozo answered that as above quoted.

The administrative construction referred to, and plainly appearing in the stipulation then filed by the counsel for the Federal Communications Commission, is not present in any of the other cases to which our attention has been called: and in this case, for that reason, if for no other, is clearly to be distinguished from those cited. That administrative construction, if none other, it seems to us, precludes the action now taken until (1) there has been a "fair consideration of all the circumstances", and (2) unless the difference between the original and present cost is not "a true increment of value" but is a "fictitious or paper increment"; and action to obliterate must depend upon "evidentiary circumstances" later to be developed.

Here there has been no determination whether the difference between original cost and the price claimed to have been paid is a true increment of

value, unless it is the arbitrary determination that it cannot be because it is the result of a transaction between a parent and an affiliate. There might be real doubt to make such a determination if based upon any such theory. *New York Edison Co.* v. *Maltbie,* 244 App. Div. 685–689, aff'd 271 N. Y. 103.

The order under review proceeds upon the theory that plaintiff's accounting in question was improper when made and should be corrected. In our opinion the entires made at the time of the four transactions in question accorded with the system prescribed by the Interstate Commerce Commission. They were recorded at "actual money costs", and we do not understand that the fairness of the appraisals then made is questioned. Defendants' position is that the fairness of the appraisals is immaterial because in transactions between affiliates the transferee is bound to take the transferor's net book cost. But if the entries were correct when made, as we now determine, the defendant Commission, under the present record, cannot apply retroactively a new system to write down the plaintiff's surplus. *Arizona Grocery* v. *Atchison Ry.,* 284 U. S. 370–389.

That this is so seems all the more true in view of the stipulation of these same defendants made in *A. T. & T.* v. *U. S., supra;* certainly in the absence of proof that the excess of price over the seller's net book cost was not a "true increment of value". There has not been any determination

based upon a fair consideration of all the circumstances in accordance with the stipulation mentioned, nor upon the evidentiary circumstances referred to in the opinion of the Supreme Court.

The motion for summary judgment is, therefore, denied.

Dated: August 24, 1944.

THOMAS W. SWAN,
U. S. Circuit Judge.
JOHN W. CLANCY,
U. S. District Judge.
JOHN BRIGHT,
U. S. District Judge.

U. S. GOVERNMENT PRINTING OFFICE: 1948

No. 55

In the Supreme Court of the United States

October Term, 1945

The United States of America and Federal Communications Commission, appellants

v.

New York Telephone Company

On appeal from the District Court of the United States for the Southern District of New York

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BRIEF FOR THE UNITED STATES AND THE FEDERAL COMMUNICATIONS COMMISSION

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 55

THE UNITED STATES OF AMERICA AND FEDERAL COMMUNICATIONS COMMISSION, APPELLANTS

v.

NEW YORK TELEPHONE COMPANY

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE UNITED STATES AND THE FEDERAL COMMUNICATIONS COMMISSION

OPINION BELOW

The opinion of the court below (R. 109–118) is reported in 56 F. Supp. 932–938.

JURISDICTION

The judgment of the court below was entered on January 2, 1945 (R. 118–119). A petition for appeal was filed on February 24, 1945, and was allowed on February 26, 1945 (R. 131–133). On May 7, 1945, this Court noted probable jurisdiction (R. 138). The jurisdiction of this Court on

appeal rests on the provisions of the Urgent Deficiencies Act of October 22, 1913, c. 32, 38 Stat. 219, 220 (28 U. S. C. 47, 47a) as extended by Section 402 (a) of the Communications Act of 1934, c. 652, 48 Stat. 1064, 1093, as amended, c. 229, 50 Stat. 189, 197 (47 U. S. C. 402 (a)).

QUESTIONS PRESENTED

1. Whether the order of the Federal Communications Commission, directing the appellee to charge $4,166,510.57 to its surplus account and to make appropriate concurrent entries on the ground that this amount is an inflationary write-up resulting from transfers between a parent corporation and its controlled affiliate, is consistent with the memorandum filed by the Commission with this Court in *American Telephone and Telegraph Company* v. *United States,* 299 U. S. 232.

2. Whether the Commission's order, applicable to accounting with respect to transactions which took place before the Commission came into existence, and with respect to property some of which has been retired, is nevertheless within the Commission's authority.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Communications Act of 1934 and of the Commission's Rules and Regulations are set forth in the Appendix, *infra*, pp. 53–59.

STATEMENT

This is a suit in equity brought, on February 11, 1944, by the New York Telephone Company against the United States and the Federal Communications Commission to enjoin, set aside, annul and suspend an order adopted by the Commission, on December 14, 1943, requiring the New York Telephone Company to debit the amount of $4,166,510.57 to its Account 413 "Miscellaneous debits to surplus" and to make concurrent entries to other appropriate accounts (R. 1–56). On March 29, 1944, appellants filed a motion for summary judgment, together with the supporting affidavit of Charles R. Denny to which was attached as an exhibit the record of the proceedings before the Commission which had culminated in the issuance of the order in question (R. 57–65, 135).[1] The grounds for the motion were that the complaint and exhibits annexed thereto, the annexed affidavit, and the record of proceedings before the Commission showed that there was no genuine issue

[1] Pursuant to order of the court below, the administrative record (which consists of 3,000 pages and 84 exhibits) has been transmitted to this Court as an original document. The parties have stipulated, subject to the approval of this Court, that the administrative record need not be printed as part of the record but that either party may refer in its brief to any portion thereof and may include in the appendix to the brief such portion of the administrative record as may be deemed relevant (R. 135–136). The pages of the administrative record have been consecutively numbered and reference thereto will be indicated by "Tr."

as to any material facts and that the appellants herein were entitled to judgment as a matter of law. On August 24, 1944, the court below handed down its opinion denying the motion for summary judgment (R. 108–118) and, on January 2, 1945, made findings of fact and conclusions of law (R. 119–130), and entered its judgment and order permanently enjoining, setting aside, suspending and annulling the order of the Commission (R. 118–119).

A. *The parties.*—The appellants are the United States of America and the Federal Communications Commission. The United States is a party because of the requirement of the Act under which the suit is brought. The Federal Communications Commission (hereafter referred to as "the Commission"), created by the Communications Act of 1934, as amended (47 U. S. C. 151, *et seq.*) to administer the provisions of that Act, has jurisdiction over the charges, services, facilities, practices, classifications, and regulations for and in connection with interstate and foreign radio and wire communication service. (R. 120.) From 1910 to 1934, some of the jurisdiction which the Commission now exercises with respect to telephone carriers was vested in the Interstate Commerce Commission (R. 122).

Appellee is the New York Telephone Company, a New York corporation, furnishing telephone exchange and interstate and intrastate message

toll service in the States of New York and Connecticut (R. 120). It is one of the Bell System companies and is thus affiliated with numerous other telephone companies operating throughout the United States. The top holding company of the Bell System is the American Telephone and Telegraph Company (hereafter referred to as "A. T. & T.") which owns 100% of appellee's common stock (R. 121), all or a majority of the capital stock of eighteen other Bell System telephone companies, and a substantial minority of the capital stock of two other Bell System telephone companies; it also owns stock or other financial interests in manufacturing, research, sales, and other companies. In addition to its holding company activities, A. T. & T., through its Long Lines Department, conducts nationwide telephone operations. Certain of the Bell System companies in turn own controlling stock interests or substantial minority interests in other telephone companies.[2]

B. *History of the transfers of the property involved and the accounting therefor.*—Prior to 1925, both New York Telephone Company and A. T. & T. furnished intrastate, as well as interstate, toll service in New York State. In that year, A. T. & T., as part of a plan to withdraw

[2] For a more complete description of the composition of the Bell System, see Report of Federal Communications Commission on Investigation of the Telephone Industry in the United States, 76th Cong., 1st Sess., H. Doc. No. 340, pp. 65–70.

from intrastate toll business in New York State, transferred its intrastate toll business in that state to appellee. In connection with this transfer of business, A. T. & T. made two of the four transfers of property, the accounting for which is involved in this case. These transfers took place in 1925 and 1926, and consisted of outside toll plant, principally poles, wires, and cables. The third toll property transfer involved was made in 1928, when a small amount of toll plant was transferred by A. T. & T. to appellee in connection with the transfer by A. T. & T. to appellee of certain interstate toll business. Much of the property acquired by appellee in these three transfers was in the form of an additional interest in toll plant which, prior to such acquisition, was owned jointly by appellee and A. T. & T. Portions of such acquired property had been originally constructed by appellee for A. T. & T., appellee billing A. T. & T. for the cost of the construction, and A. T. & T. placing the property on its books at that cost. (R. 22–25; Tr. 77–81, 97–99, 103–109, 264, 269–274, 375–376, 429–430, 500–502, 769–770, 771–772, 786, 816, 1308–1311, 1329–1330.) During the same period (1925–1928), toll properties were similarly transferred from appellee to A. T. & T. (R. 23; Tr. 102, 144–146, 373, 500–502, 832).

The fourth property transfer involved in this case took place in 1927 and comprised three es-

sential parts of the telephone stations used by subscribers, theretofore owned by A. T. & T. These parts were the transmitter, receiver, and induction coil, and are designated collectively as "the instruments." The other parts necessary for a complete telephone station, such as the stand, bell box, etc., were owned by appellee. A. T. & T. furnished and maintained the instruments under a "license contract" between it and appellee, similar to that in effect between A. T. & T. and each of its other associated companies. Under this contract, which also covered other matters, appellee paid A. T. & T. a specified percentage of its gross revenues. A. T. & T. decided to transfer to appellee title to the instruments then in the service or in the supplies of appellee, and this was done as of December 31, 1927. (R. 23-24; Tr. 199, 209-212, 526-531, 534-535, 1491-1495, 2316-2317, 2517-2518.)[3]

The above four transfers of property did not involve any change in the physical character of the plant involved, in the service rendered to the public, or in the use of the plant rendering the service. These transactions resulted in shifting to operating costs of appellee certain expenses formerly comprised in operating costs of A. T.

[3] At the same time, A. T. & T. also transferred to its other associated companies ownership of the instruments in their possession (R. 23; Tr. 989-990).

& T., and also in shifting to appellee fixed charges and taxes connected with the ownership of the property. As an offset, appellee retained certain revenues it formerly turned over to A. T. & T. (R. 24; Tr. 212–213, 501–502, 833–834, 2316–2317.)

The amounts involved in each of the above four property transfers are shown in the table set forth below. This table shows with respect to each transfer the book cost to A. T. & T., the related book depreciation and amortization reserves on the books of A. T. & T., and the net book cost to A. T. & T. as of the time when such transfers occurred.[4] The table also shows the amounts at which the property was shown on appellee's books and the "profit" resulting to A. T. & T. from each transaction. See R. 24–25.

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[4] As used in the Commission's report, the term "book cost" means the amount at which property is carried (whether rightly or wrongly) in the Company's asset accounts. It may be, in a given instance, the original cost; it may be a price paid which is different from original cost; or it may be some other figure dependent on vagaries of bookkeeping. The term "net book cost" means the book cost minus the amount of depreciation and amortization reserves shown on the books which is related to the property for which the book cost is shown. For the purposes of the report only, it is assumed that the figures in the record for book cost to A. T. & T. of the plant in question represent the original cost of the plant, and that the book depreciation and amortization reserve figures determined by A. T. & T. and shown in the record as applicable to the plant transferred to New York are correct. (R. 24, notes 5 and 6.)

Property Group	Book cost to A. T. & T.	Related depreciation and amortization reserves	Net book cost to A. T. & T.	Recorded book cost to New York Telephone Co.	Excess or "Profit" to A. T. & T.
1925—Toll line Property	$5,010,340.19	$801,858.95	$4,208,481.24	$5,831,884.78	$1,623,403.54
1926—Toll line Property	95,924.66	14,449.20	81,475.46	97,310.39	15,834.93
1928—Toll line Property	28,077.64	4,144.78	23,932.86	44,246.30	20,313.44
1927—Telephone instruments	8,135,224.98	3,980,944.73	4,154,280.25	6,661,238.91	2,506,958.66
Total	13,269,567.47	4,801,397.66	8,468,169.81	12,634,680.38	4,166,510.57

In recording on its books each of the above four property transfers, A. T. & T. credited its plant account with the amount of its book cost shown in the above table, and debited its depreciation and amortization reserves with the amount shown for those reserves in the table. On the other hand, appellee, in each case, recorded the transfer by entering in its plant accounts the total amounts of the "prices" assigned for the properties acquired, but recorded no amount with respect thereto in its depreciation or amortization reserve accounts. In each of the four cases, the amount recorded by A. T. & T. as received from New York in excess of the net book cost to A. T. & T. of the plant transferred was credited by A. T. & T. to surplus accounts as profit on the transaction. These excess amounts, or "profits", totaled $4,166,510.57. (R. 25; Tr. 112–116, 134, 244–248, 254–259, 290–291, 361, 369–370, 473, 478–479, 483–484, 2280, 2284–2287.) As has been pointed out (*supra*, p. 6) appellee, during the period of the transfers involved here, also transferred some property to

A. T. & T. Some of this property was taken over by A. T. & T. at a figure in excess of the net book cost to appellee. Thus, as a result of mutual transfers, both A. T. & T. and appellee realized profit on their books. (R. 23, 29; Tr. 144–146, 373, 500–502.)

The difference of more than four million dollars between the net book cost to A. T. & T. of the properties transferred and the amounts recorded in the books of appellee is attributable to the facts that the original cost of the property transferred, and the depreciation which had been accrued therefor on the books of A. T. & T. to the date of transfer, were ignored. With respect to the three transfers of toll properties, the "price" was allegedly determined on the basis of "structural value" as of the time of the transfers, or estimated reproduction cost new minus a depreciation allowance, as determined by appraisals. (R. 25; Tr. 87–96, 121–126, 362–370.) The recorded cost to appellee of the instruments was based upon the average price of new instruments purchased by A. T. & T. from the Western Electric Company (a subsidiary of A. T. & T.) during the first nine months of 1927, less 20% which allegedly accounted for the used condition of the instruments. (R. 25; Tr. 534–535, 542, 555–557, 996–997, 1116–1118, 1124, 1136–1140, 2316–2317.)

Appellee entered no amount in its depreciation or amortization reserves at the time of transfer. Thereafter, it made regular annual accruals to

depreciation reserve. The amount of these entries was determined by applying to the "price" paid for the property as recorded on its books the current depreciation rates which appelleee had theretofore established with respect to the several classes of plant involved. In the case of the toll property, appellee already had property of this kind in its accounts, and it recorded the transferred property in those accounts and thereafter used the depreciation rates previously applied to amounts in such accounts. (R. 26; Tr. 121–126, 362–366, 473.) So far as the instruments were concerned, appellee had had no property of this kind before the 1927 transfer. The depreciation factor applied was that which appellee had established for the station equipment it did own based on data through the year 1925, this being done on the assumption that the remaining service life of the instruments was the same as that of the other station equipment. (R. 26; Tr. 548–554; 558–563, 1009–1010, 1018, 1022, 1036–1048, 1140–1141.)

From time to time, appellee retired portions of the acquired property from service. When this was done, estimated amounts, based upon the book cost (i. e., "price") to appellee of the property, were retired on its books by credits of such amounts to its plant accounts. At the same time, appellee debited corresponding amounts (with allowance for salvage) to its depreciation or amortization reserves. This was done although the property acquired by appellee which had already been

used by A. T. & T., was transferred at prices which purported to reflect all existing depreciation, and appellee had not thereafter applied any special depreciation rate nor made any entry in its depreciation reserve for the existing depreciation. Hence, appellee never credited its depreciation reserve with the full amount it debited thereto when it retired the property. (R. 25–26; Tr. 1198–1199, 1527, 1532–1534, 1970–1972, 1986–1988.)

In July 1934, pursuant to the Communications Act, jurisdiction with respect to the accounting followed by the New York Company was transferred from the Interstate Commerce Commission to the Federal Communications Commission (R. 124). On January 1, 1937, following the decision of this court in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232, the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies became effective [5] and its provisions are applicable

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[5] This System of Accounts is contained in Part 31 of the Commission's Rules and Regulations. A copy of these Rules and Regulations is being filed with the Clerk for the convenience of the Court.

On June 19, 1935, the Commission adopted its Order No. 7–C which prescribed a Uniform System of Accounts for Telephone Companies having average annual operating revenues exceeding $50,000, effective January 1, 1936 (1 F. C. C. 45). The operation of Order No. 7–C was stayed because of the proceeding in the case of *American Telephone and Telegraph Company* v. *United States*, in which the validity of this Uniform System of Accounts was attacked by the

to appellee as a Class A telephone Company. A key provision of this System of Accounts is the requirement that telephone companies set up or reclassify their investment accounts (Accounts 100.1 to 100.4—Secs. 31.100:1–31.100:4) on the basis of original cost. "Original cost" is defined (Sec. 31.01–3 (x)) as "the actual money cost of * * * property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors." The system further provides that Account 100.4 (Sec. 31.100:4), "Telephone plant acquisition adjustment," shall include amounts 'representing the difference between (1) the amount of money actually paid * * * for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired."

Appellee did not reclassify on an original cost basis the amounts in its accounts associated with

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American Telephone and Telegraph Company, the New York Company, other Bell System Telephone Companies, and certain other telephone companies. After the decision of the Supreme Court of the United States on December 7, 1936 (299 U. S. 232), sustaining the validity of the Commission's Uniform System of Accounts, the Commission adopted its Order No. 7-D which amended Order No. 7-C in certain respects and made the amended System of Accounts effective January 1, 1937 (3 F. C. C. 9).

the transfer of the telephone instruments in 1927 (R. 27; Tr. 143, 149, 193–194, 204, 484–485). It did purport to reclassify its accounts, as of January 1, 1937, for the toll plant transferred to it by A. T. & T. in 1925, 1926, and 1928, and it placed $483,975.83 in Account 100.4.[6]

In 1938, appellee began amortizing the amounts included in its Account 100.4 by charges and credits to its operating expense Account 614 (Sec. 31.614), "Amortization of telephone plant acquisition adjustment", with concurrent entries to its Account 172 (Sec. 31.172), "Amortization re-

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[6] Appellee reclassified its accounts by estimating the book cost to it of the toll plant which still survived as of 1937. Next, the original cost of such surviving plant, as originally reflected on the books of A. T. & T., i. e., book cost to A. T. & T., was determined. The latter figures were set up in Account 100.1 of appellee to represent the amount of such surviving property as "plant in service." The difference between this "original cost" and the book cost to appellee was placed in Account 100.4. This amount was $483,975.83. No amount was credited to appellee's Account 171 (Sec. 31.171), "Depreciation reserve," in the process of reclassification. (R. 27; Tr. 116–120, 131–133, 146–147, 248–249, 473–475, 1279–1283, 1288–1293, 2281, 2282.)

In connection with appellee's plan for disposition of amounts included in Account 100.4, it transferred, in 1937, from its Account 171 to its Account 172 (Sec. 31.172), "Amortization reserve," an amount which, when supplemented by future accruals over the estimated remaining life of the plant at the then current depreciation rates for the respective plant classes, would provide a reserve equivalent to the amount in question in Account 100.4 at the termination of the life of the property involved (R. 27; Tr. 147–149, 249–250, 474, 1293–1294, 2283). For the disposition which the Commission made of this amount placed in the "Amortization reserve", see R. 41–42.

serve". From time to time, when portions of the acquired plant were retired, amounts in Account 100.4 were written out of that account with a concurrent entry to Account 172. Such amortization charges to Account 614 were suspended by the Commission's order of June 16, 1942. (R. 47, 48, Tr. 120, 149.)

C. *Proceedings before the Commission.*—On June 16, 1942, the Commission adopted an order instituting a general investigation into the accounting performed and the accounts, records and memoranda kept by appellee at the time of and during the period since the four transfers of property involved in this suit. Appellee was required to show cause why the amount of $4,166,510.57 should not be charged to its Account 413 (Sec. 31.413), "Miscellaneous debits to surplus," with concurrent entries to such accounts as may be appropriate. As has been noted, the order of June 16, 1942, also suspended all charges to operating expense accounts made by appellee on and after January 1, 1942, for the purpose of or in conjunction with amortizing or otherwise disposing of amounts included in its Account 100.4, "Telephone plant acquisition adjustment", pending submission of proof by appellee of the propriety and reasonableness of such charges. (R. 47–49.)

A hearing was ordered to be conducted jointly with any hearings involving similar matters which might be ordered for the same time and place by the Public Service Commission of New York and

the Connecticut Public Utilities Commission. Joint extensive hearings were held before two Commissioners of the Federal Communications Commission and two Commissioners of the New York Public Service Commission. Appellee participated and presented evidence at these hearings. Evidence was also submitted by members of the staff of both Commissions and by witnesses called on behalf of both Commissions. (R. 22, Tr. generally.)

On January 19, 1943, appellee filed its proposed findings of fact and conclusions and supporting brief with the Commission (R. 22, Tr. 2719–2809). On June 22, 1943, the Commission issued its proposed report in which it concluded that the amount of $4,166,510.57 should be charged to Account 413, "Miscellaneous debits to surplus", with concurrent entries to appropriate accounts specified in the proposed report (R. 65–76). On July 16, 1943, appellee filed exceptions to the Commission's proposed report, together with a supporting brief, and requested oral argument before the Commission (Tr. 2822–2906, R. 77–107). Oral argument was held before the Commission *en banc* on September 22, 1943 (Tr. 2920–2963), and on December 14, 1943, the Commission issued its final report and order (R. 20–43).[7]

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[7] On December 14, 1943, the New York Public Service Commission also adopted its final report and reached the same conclusions as did the Commission (R. 22, Tr. 2990–3031).

The Commission held that the accounting performed by appellee with respect to the four property transfers involved was improper and resulted in a purely inflationary write-up of its plant accounts to the extent of the amounts entered therein in excess of the net book cost to A. T. & T. of the property. The Commission further held that the inflation was not removed by the fact that some of the property transferred had been retired. As to the retired property, the inflation remained in the form of a deficiency in the depreciation reserve account, since the debit to the depreciation reserve of the entire book cost (to appellee) of the property retired was made despite the fact that insufficient credits had been made to the reserve account for purposes of retirement of the property. The Commission also held that, contrary to appellee's contention, the Interstate Commerce Commission's rules in effect at the time of the transfer did not require the accounting performed by New York, and that, in any event, the Federal Communications Commission was not bound by the accounting rules prescribed by the Interstate Commerce Commission. Finally, the Commission held that the supplemental memorandum presented to the Court by the Federal Communications Commission in the case of *American Telephone and Telegraph Company* v. *United States,* 299 U. S. 232, could not be construed as preventing the Commission from requiring ap-

pellee to write out of its surplus account the amount of inflation which the Commission found in this case to exist in appellee's accounts. (R. 22-40.)

The Commission's order, accompanying the final report, directed appellee to debit the amount of $4,166,510.57 to its Account 413, "Miscellaneous debits to surplus," and to make appropriate concurrent entries to accounts specified in the order (R. 41-43).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

(1) In denying appellant's motion for summary judgment.

(2) In issuing the injunction prayed for by appellee.

(3) In holding that the Federal Communications Commission was without power to promulgate the order sought to be set aside by appellee, and in failing to hold that the Federal Communications Commission had authority to promulgate the said order.

(4) In holding that the action of the Commission in requiring the New York Telephone Company to write off from its accounts, amounts paid by it to American Telephone and Telegraph Company for property acquired from that company in excess of the net book cost of the property to that company at the time of the purchase did not constitute a fair consideration of all the circum-

stances and was not a valid determination that such excess was not a true increment of value within the meaning of the supplemental memorandum filed by the government in the case of *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232, and that the Commission's action was therefore in violation of the terms of that supplemental memorandum.

(5) In holding that the accounting entries here involved were made in compliance with then applicable rules and regulations of the Interstate Commerce Commission.

(6) In holding that the order of the Commission is invalid because it sought to apply retroactively the Federal Communications Commission's System of Accounts to write down appellee's surplus by requiring changes in certain accounting entries originally made by appellee in accordance with regulations of the Interstate Commerce Commission.

SUMMARY OF ARGUMENT

I

The order of the Commission here challenged is in conformity with the supplemental memorandum filed by the Government in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232. That memorandum and the opinion of this Court in that case make it clear that it was contemplated that the Commission would decide whether, in a particular case, amounts carried on the books of a corporation

represented a "true investment". There is an abundance of evidence to support the Commission's determination here that a company makes no such "true investment" when the transfer is between a parent and its controlled affiliate. Such a transaction is essentially identical with the situation created when a company writes up the value of its properties on its own books.

Having found that the amount recorded on appellee's books with respect to the properties transferred, over and above their net book cost to the transferor, was not related to any additional investment, the Commission properly required the carrier to remove from its books increments of value claimed to have been recognized at the time of the transfer. *Colorado Interstate Gas Company v. Federal Power Commission,* 324 U. S. 581, rehearing denied, April 30, 1945, No. 379, 1944 Term.

II

The order is valid and within the Commission's authority although it applies to accounting with respect to transactions which took place before the Commission was in existence. Whether or not the original accounting here involved was in accordance with the Interstate Commerce Commission's system of accounts in effect at the time of the transfers in issue, the Commission possesses the authority, under Section 604(a) of the Communications Act of 1934, to supersede the Interstate Commerce Commission's system of accounts

and to require the company to restate its accounts. *American Telephone and Telegraph Company* v. *United States, supra.* Thus, where the accounting with respect to a transaction long since past continues to have present and future significance, the Commission may continue to exercise its jurisdiction and to inquire whether such accounts are properly stated. When the Commission finds that they are not properly stated and requires appropriate adjustment, it is not imposing a penalty for a failure in the past to record the transaction in conformity with a system of accounts not then in existence but is rather requiring the restatement of existing balances, as they are affected by these past transactions, so that these balances may be accurately stated.

III

In this case, the accounting performed with respect to the transfer between A. T. & T. and appellee presently results in a misstatement still reflected in the accounts, although some of the property has already been retired. The record clearly shows that there is such a misstatement. The depreciation of the property which appellee acquired from A. T. & T. was accounted for by appellee at annual rates which did not take into consideration the fact that the property was partly depreciated at the time of its acquisition, and was entered on its books at a figure which purported to reflect existing depreciation, with nothing be-

ing included in the depreciation or amortization reserves with respect to the property. As a result, when the property reached the end of its service life, insufficient amounts had been accumulated in appellee's depreciation reserve to cover the cost of the property as carried in appellee's plant accounts. Thus, when the property in question was retired and appellee's book cost of the property was credited to plant account and the same amount was debited to depreciation reserve, appellee charged to the depreciation reserve more than had been credited thereto; the excess being at least as much as the amount of the write-up with respect to that property. This resulted in moving the inflation from the plant accounts to the depreciation reserve in the form of a deficiency in the reserve. Under this type of accounting, the retirement of property could not possibly have removed any of the inflation which was introduced into the accounts when the transfers took place.

ARGUMENT

I

THE COMMISSION'S ORDER IS CONSISTENT WITH THE SUPPLEMENTAL MEMORANDUM FILED BY THE GOVERNMENT IN *AMERICAN TELEPHONE AND TELEGRAPH COMPANY V. UNITED STATES*, 299 U. S. 232

The court below held that the Commission's order violates the terms of the supplemental memorandum filed by the government in *American Telephone and Telegraph Company* v. *United*

States, 299 U. S. 232. Before discussing this point a brief statement of the history and nature of the Commission's Uniform System of Accounts and of the litigation following its adoption may be helpful.

The Federal Communications Commission is authorized by Section 220 (a) of the Communications Act of 1934 (47 U. S. C. 220 (a)) to prescribe, in its discretion, forms of accounts for carriers subject to its jurisdiction. Under Section 220 (c), when the Commission questions an accounting entry made by a carrier, the burden of proof is on the carrier to justify the entry in question. The Commission's Uniform System of Accounts became effective on January 1, 1937. This system of accounts is an "original cost" system, unlike the system of accounts which had been prescribed by the Interstate Commerce Commission. Hence, appellee was required to reclassify its accounts on an original cost basis. In brief, this required appellee to record in Account 100.1 ("Telephone plant in service") the "actual money cost of * * * property at the time it was first dedicated to the public use, whether by the accounting company or by predecessors" and to record in Account 100.4 ("Telephone plant acquisition adjustment") amounts "representing the difference between (1) the amount of money actually paid * * * for telephone plant acquired, plus preliminary expenses incurred in

connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired."

When the Commission's Uniform System of Accounts was promulgated, and before it became effective, suit was filed by appellee, A. T. & T., and other telephone companies to set it aside. Among other contentions, the argument was made that the system of accounts was unlawful on the ground that the amounts in Account 100.4, representing the difference between the price paid for property and original cost of that property when first dedicated to the public use, would have to be written off summarily by the carrier without any opportunity to amortize such amounts by charges to operating expenses. The Commission asserted that this was an incorrect interpretation of the provisions of Account 100.4. In order to clarify this and other points raised by the telephone companies, the Government, at the request of this Court, submitted a supplemental memorandum which reads as follows with respect to Account 100.4 (R. 46):

> (1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until

> such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.
>
> (2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 196) or account 675 (R. 205).

The Court accepted the supplemental memorandum as a binding construction by the Commission. With respect to the supplemental memorandum, and in answer to the contention that amounts in Account 100.4 would in all cases have to be summarily written off, this Court said (p. 240–241):

> The Commission is not under a duty to write off the whole or any part of the balance in 1004, if the difference between original and present cost is a true increment of value. On the contrary, only such amount will be written off as appears, upon an application for appropriate directions, to be a fictitious or paper increment. This is made clear, if it might otherwise be doubtful, by administrative construction.

In the instant case, the Commission found that the amount by which the so-called prices which appellee paid to its parent company, A. T. & T.,

exceeded the net book cost of that property to A. T. & T. merely represented a "fictitious or paper increment" within the meaning of this Court's opinion in *A. T. & T.* case because it resulted from purely formal transactions between parent and subsidiary incapable of bargaining at arm's length.[8] As the Commission stated in its report (R. 28–29):

> This accounting resulted in a purely inflationary write-up of New York's plant

[8] Many witnesses experienced in the field of regulation of public utility accounting testified before the Commission that when property is transferred from a parent to a controlled affiliate, proper accounting requires that the property be entered on the books of the affiliate on the same basis, as to plant account and depreciation reserve, as it was carried on the parent's books. These witnesses were Mr. William Norfleet, Chief Accountant of the Federal Communications Commission (Tr. 1608–1613, 2023–2024, 2026–2029, 2035–2036, 2041, 2082–2085); Mr. Henry Long, Chief of the Accounting Regulations Division of the Federal Communications Commission (Tr. 1179–1185, 1192–1199, 1202–1206, 1207–1210, 1929–1933); Mr. Charles W. Smith, Chief of the Bureau of Accounts, Finance and Rates of the Federal Power Commission (Tr. 1593–1602, 1627–1631, 1952–1954); Mr. Clyffe Crandall, Director of the Bureau of Accounts of Interstate Commerce Commission (Tr. 1170–1177, 1559–1560, 1562–1564, 1567–1575); and Mr. Malcolm F. Orton, Director of Research and Valuation of the New York Public Service Commission (Tr. 1721–1727, 1985). See also, Montgomery, *Auditing Theory and Practice*, as quoted in Tr. 1508–1510, 1619–1622. Although appellee produced witnesses who testified that in their opinion the accounting followed by appellee was proper, it is significant that they did not state that the type of accounting prescribed by the Commission's order is at all improper. Indeed, as early as 1914 and continuing throughout the period of the transfers in question and up to 1934,

> accounts by the amounts entered therein in excess of the net book cost to A. T. & T. of the plant involved. These excess amounts represented a "profit" to A. T. & T. Since New York was then, as it is now, fully subject to control by A. T. & T., the inter-company profits to A. T. & T. resulting from the affiliated company transfers of property involved herein are fictitious or paper increments, and are as unreal as profits from interdepartmental transactions.

Accordingly, the Commission found that the amount of these write-ups had no place in the appellee's accounts.[9]

The court below held (R. 117) that this finding by the Commission was erroneous because the

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the Bell System companies themselves, including appellee, were taking the position before the Interstate Commerce Commission that it was proper accounting to use the transferor's book figures as the basis for accounting for intra-system affiliated company transfers (R. 34, Tr. 495, 727–728, 732–733, 747–749, 752–754, 2264–2265, 2339–2378). Of about 37,200 Bell System acquisitions of property in the period 1916 to 1935, totalling more than $680,000,000 in consideration paid, the great majority of the transactions, aggregating about $478,000,000, were accounted for by the transfer of amounts in the transferor's plant and reserve accounts to the corresponding accounts on the books of the acquiring company (Tr. 495, 2264–2265).

[9] Accounting witnesses called by the Commission testified that there was no objection to using Account 100.4 for control purposes; that there was no objection to the amount of the fictitious increment finding temporary resting place there, so long as it was immediately written off (Tr. 1599–1601, 1612, 1668–1676, 1693–1697, 1726–1727, 2040, 2042, 2091–2092).

Commission was required by the supplemental memorandum filed by the government in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232, to determine whether the difference between original cost and the price claimed to have been paid is a true increment of value and that the Commission's finding that the difference did not represent a true increment of value because it resulted from a transaction between a parent and its controlled affiliate did not constitute such a determination. The court did not indicate the nature of the determination which the Commission would be required to make in this type of case, but judging from its reliance (R. 117, 122) on the fact that the Commission had made no determination of the value of the property at the time of the transfer, it seems clear that the court below was of the opinion that the Commission could not require a write-off of the amounts in question without undertaking a valuation of the property transferred in order to determine whether appellee paid more for the property than it was worth.

The fallacy in the court's reasoning lies in its attempt to treat the accounting for transactions between a parent and its controlled affiliate in exactly the same way that bona fide arms' length transactions between independent parties might be treated. Apart from the question of what consideration the Commission may be required to

give to value with respect to the accounting for a transaction between independent parties in determining whether any excess of purchase price over original cost represents an investment in assets of continuing value, to require a consideration of value in cases involving transactions between a parent and its controlled affiliate would make an idle gesture of an original cost system of accounts. For example, if instead of a transfer between a parent and an affiliate, a corporation simply wrote up the assets on its books or transferred the assets from one department to another department at a figure higher than original cost, the Commission would certainly not be required to go through a valuation proceeding before requiring the amount of the write-up to be stricken from the books. Whether or not the property had appreciated in value would not be relevant. To hold that a different result is required simply because the transfer is not from one department of the company to another but is to a separate controlled corporation is to exalt form at the expense of substance. Such a rule would permit corporations, by the simple device of making transfers to wholly owned subsidiaries, to increase the amounts at which the property is carried on their books, and make the Commission powerless to compel appropriate accounting adjustments without costly, time-consuming and extensive valuation proceedings to determine the

value of the property. Valuation questions are conjectural enough even when the parties are dealing at arms' length (*Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 599–609); the absence of arms' length bargaining renders such questions completely unrealistic.[10]

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[10] In discussing similar contentions of appellee in the proceedings before the Commission, the Commission stated in its Report (R. 30–31):

"All of these contentions ignore the important fact that New York was and is a wholly owned subsidiary of A. T. & T., and therefore fully subject to A. T. & T.'s control. This fact makes the fairness and reasonableness of the "prices" paid in such a transfer of property between such affiliated companies completely unrealistic as a measure of investment in plant. There was and could be no arms'-length bargaining between A. T. & T. and New York with respect to the amounts so paid. Any method of accounting which results in the inclusion in plant investment accounts of amounts based upon 'values' agreed upon between a wholly owned subsidiary and its parent which are greater than legitimate net book cost to the transferor would nullify accounting from a regulatory standpoint. The full ultimate impact of such inflationary elements in the plant accounts is in time improperly reflected in the depreciation expense account as an alleged operating cost, unless, by proper regulatory requirements, the balance sheet is cleared, or in the first instance is kept free, of such inflationary elements. Accounting, for purposes of efficient regulation of public utilities, must be firmly grounded on the cost principle, and if the investment recorded in the accounts is to have some relationship to the actual investment dedicated to the public use by an affiliated group of companies, such agreed 'values' must not be allowed to exist as a distortive element in their investment accounts. Certainly such 'values' cannot be represented by an estimate of such an inherently speculative nature as reproduction cost less depreciation, or 'structural'

The absurd extent to which such a practice could lead is demonstrated by the facts of this case. As has been pointed out, during the period when A. T. & T. transferred the property involved in this suit to appellee, appellee also transferred other property to A. T. & T. As in the transfers involved in this suit, some of the transfers from appellee to A. T. & T. were at a price higher than the original cost to appellee. With no increase in property, and with no change in service, the combined surplus of the companies was increased. Thus, while no one would contend that A. T. & T. or appellee could by their own action properly write up the value of these assets on their own books, by the simple device of having A. T. & T. and appellee exchange ownership in certain property, the same write-up is achieved. If such a practice were permitted it would make the original cost system of accounts largely ineffective in the telephone field in which a large part of the business is in the hands of companies under common control (see *American Telephone*

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value.' Otherwise transfers of property between affiliated companies would provide a device to establish write-ups to any desired 'structural value.' 'Structural value' at best requires conjecture, involving as it does estimates as to what certain property might have cost to reproduce, assuming it were to be reproduced in new condition at the prices in effect at the time when the estimates are made; and further involving estimates as to existing depreciation in the property, based on obsolescence and inadequacy, as well as wear and tear."

and Telegraph Co. v. *United States*, 299 U. S. 232, 238–239).

This Court, in the *American Telephone and Telegraph* case, made it perfectly clear that it did not propose to "define or catalogue" the circumstances under which a write-off of items in Account 100.4 would be permissible. All that this Court was there called upon to decide was the propriety of the segregation of certain items into Account 100.4. The Court had no need to, and did not, decide whether the price paid on an acquisition of property may be disregarded when the parties to the transaction are parent and subsidiary. This Court left to the Commission the power to determine when a company has made a "true investment" (299 U. S. at 242), and there is an abundance of evidence in this record (see *supra*, note 8, pp. 26–27) to sustain the Commission's determination that appellee made no such "true investment" when it paid its parent more than four million dollars in excess of the net book cost of the property to A. T. & T. It was entirely within the Commission's discretion to decide that the affiliation between A. T. & T. and appellee required non-recognition of the profit which resulted from the transfers in question. Given the facts of affiliation and control, the Commission, endowed with a special competence, and charged with the duty of determining whether appellee's accounts reflect a fictional investment, was free

to infer from these facts, and these facts alone, that the increment on appellee's books was merely an inflationary write-up. Cf. *National Labor Relations Board* v. *Regal Knitwear Co.*, 140 F. 2d 746, 747 (C. C. A. 2), affirmed, 324 U. S. 9; see also *Republic Aviation Corp.* v. *National Labor Relations Board,* decided by this Court on April 23, 1945, slip opinion, pp. 4–5; see also cases cited *infra,* p. 34, note 11.

The recent decision by this Court in *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U. S. 581, rehearing denied, April 30, 1945, No. 379, 1944 Term, supports the Commission's interpretation of the *American Telephone and Telegraph Company* case. That case involved a transfer of certain oil-producing properties between affiliated companies controlled by the same holding company at a price which the parties contended represented the fair value of the property but which exceeded the original cost of the property. It was argued that there had been a real appreciation in property values and that the Federal Power Commission was without authority to require exclusion of the amount of the write-up from the rate base of the company to which the transfer was made. This argument was rejected by this Court, which held that the Federal Power Commission had ample authority to require the amount of the write-up to be eliminated from the

rate base.[11] The Court said (324 U. S. at 607–608):

> Canadian contends that the Commission should have included $5,000,000 in the rate base for the gas leases and producing properties acquired from Amarillo. The original cost of the properties to Amarillo was $1,879,504. That is all the Commission allowed. It said, "Any treatment which would permit the capitalization of such amounts would open the door to the renewal of past practices of the utility industry when properties were traded between affiliated interests at inflated prices with the expectation that the public would foot the bill." 43 P. U. R. (N. S.) p. 215.

[11] The lower federal courts have consistently sustained the authority of the Federal Power Commission to require the elimination of profits resulting from transfers of property between affiliated companies. *The California Oregon Power Co.* v. *Federal Power Commission*, 150 F. 2d 25 (C. C. A. 9); *Pennsylvania Power & Light Co.* v. *Federal Power Commission*, 139 F. 2d 445 (C. C. A. 3); *Niagara Falls Power Co.* v. *Federal Power Commission*, 137 F. 2d 787 (C. C. A. 2), certiorari denied, 320 U. S. 792; *Alabama Power Co.* v. *Federal Power Commission*, 134 F. 2d 602 (C. C. A. 5); *Louisville Gas & Electric Co.* v. *Federal Power Commission*, 129 F. 2d 126 (C. C. A. 6), certiorari denied, 318 U. S. 761; *Alabama Power Co.* v. *Federal Power Commission*, 128 F. 2d 280 (App. D. C.), certiorari denied, 317 U. S. 652; *Northern States Power Co.* v. *Federal Power Commission*, 118 F. 2d 141 (C. C. A. 7); *Alabama Power Co.* v. *McNinch*, 94 F. 2d 601 (App. D. C.). See also *Natural Gas Pipeline Co.* v. *Slattery*, 302 U. S. 300, 307; *Western Distributing Co.* v. *Public Service Commission of Kansas*, 285 U. S. 119, 124; *United Fuel Gas Co.* v. *Railroad Commission of Kentucky*, 278 U. S. 300, 310.

We agree. Southwestern owned the producing properties at the beginning of the transaction through one subsidiary; it owned them at the end of the transaction through another subsidiary. As between Southwestern and its subsidiaries there was no more than an intercompany profit. * * * The end result is that property has been transferred at a write-up from one of Southwestern's pockets to another. The impact on consumers of utility service of write-ups and inflation of capital assets through intercompany transactions or otherwise is obvious. The prevalence of the practice in the holding company field gave rise to an insistent demand for federal regulation. See S. Doc. No. 92, Pt. 84–A, 70th Cong., 1st Sess. Utility Corporations, Final Report of the Federal Trade Commission (1936); Bonbright & Means, The Holding Company (1932), ch. VI; Barnes, The Economics of Public Utility Regulation (1942) pp. 95 *et seq.*

American T. & T. Co. v. *United States*, 299 U. S. 232, is not opposed to our position. It merely indicates a proper treatment of an intercompany transaction where in fact an additional investment is shown to exist.

The inter-affiliate transactions involved in the instant case fall perfectly into this description by the Court of a purely inflationary write-up. Here, as in the *Colorado Gas Company* case, property has been transferred between controlled compa-

nies at a price in excess of original cost of that property to the transferor. In this case, as in the *Colorado Gas Company* case, the companies contend that the property was in fact worth what the controlled subsidiary paid for it. The elimination by the Federal Power Commission of the write-up in the *Colorado Gas Company* case was held to be consistent with this Court's opinion in the *American Telephone and Telegraph Company* case. On the same reasoning, the action of the Federal Communications Commission here challenged was proper.

II

THE COMMISSION'S ORDER IS VALID EVEN THOUGH IT APPLIES TO ACCOUNTING WITH RESPECT TO TRANSACTIONS WHICH OCCURRED BEFORE THE COMMISSION CAME INTO EXISTENCE

The court below held that the accounting performed by appellee at the time the transfers in question took place was in accordance with the rules of the Interstate Commerce Commission and that the Federal Communications Commission could not retroactively change those rules. The accounting for the specific transactions in question, however, was never submitted to the Interstate Commerce Commission for a ruling, nor was any ruling ever made by the Interstate Commerce Commission with respect to the accounting therefor.[12] Although the Communications Commission,

[12] The evidence showed that beginning as early as 1914, shortly after the Interstate Commerce Commission's system

in its report, held (R. 32–34) that appellee's accounting was not required or authorized by the then applicable rules of the Interstate Commerce Commission, the Government does not consider a ruling on this point essential to the proper disposition of the case. The Commission's report (R. 34) makes it clear that the Commission did not consider itself bound by the accounting requirements of the Interstate Commerce Commission and felt free to impose new and different requirements when it was thought necessary to do so. The court below denied that the Commission had such authority.

It is difficult to reconcile this holding of the court with the express provisions of the Com-

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of accounts became effective, and continuing throughout the period when the transfers involved in this case took place, and up until 1934, the Bell System companies, including appellee, repeatedly requested, and received, from the Interstate Commerce Commission rulings that it was proper to account for acquisitions of the type involved here by transferring the book figures of the transferor to the books of the transferee. These cases represented the great bulk of the property involved in all intra-Bell System transfers: of about 300 intra-Bell System transfers of property in the period 1913–1932, involving charges to plant accounts of $50,000 or more, about 170 of the cases were transfers on the basis of the transferor's book figures. Although the evidence shows that other intra-Bell System transfers like the one involved in this case were made on some basis other than the transferor's book costs, none of these transfers of property was ever presented to the Interstate Commerce Commission for a ruling nor was any ruling ever given thereon by the Interstate Commerce Commission (R. 33, 34; Tr. 495, 707–708, 727, 729, 732, 734, 747, 749, 752–754, 1176–1177, 1579, 1582, 2264–2265, 2339–2378). Cf. note 8, pp. 26–27, *supra*.

munications Act., Section 604 (a) of the Communications Act, *infra*, p. 54, specifically provides that the orders, determinations, rules and regulations of the Interstate Commerce Commission shall remain in effect only until they are modified, terminated, superseded or repealed by the Federal Communications Commission. The Commission, by Section 220, is expressly authorized to prescribe a uniform system of accounts, and clearly can prescribe a system of accounts different from that which was prescribed by its predecessor, the Interstate Commerce Commission. Since accounting entries record past transactions, they must inevitably concern matters which are irretrievably past. But the significance and utility of books of account are necessarily present and prospective, and the books are intended for the present and future guidance not only of the regulatory agencies, but of investors, creditors, and the public. "The very object of a system of accounts is to display the pertinent financial operations of the company, and throw light upon its present condition" (*Kansas City Southern Ry.* v. *U. S.*, 231 U. S. 423, 440). A carrier subject to regulatory control, therefore, acquires no vested right in the system of accounting which prevailed at the time a particular transaction took place. If this were not so, a continuing regulatory jurisdiction over accounting practices would be wholly robbed of significance.

When the Federal Communications Commission adopted its Uniform System of Accounts based upon original cost, it adopted a system different in important respects from that which had been prescribed by the Interstate Commerce Commission. As a result, carriers were required to reclassify their accounts on the basis of the original cost provisions of the new system of accounts. This meant that some of the accounting with respect to certain transactions which had been entered into by telephone companies in the past, in accordance with the applicable rules of the Interstate Commerce Commission, had to be adjusted to conform to the System of Accounts of the Federal Communications Commission. The Commission's right to require such changes was one of the issues in the *American Telephone and Telegraph Company* case, and the Commission's authority was expressly sustained by the decision of the Court in that case.

On analysis, the district court's holding of retroactivity seems to be based on a misapprehension; it seems to have had the impression that the Federal Communications Commission was attempting to impose a penalty for appellee's past failure to keep accounts in accordance with a standard not then existing and only subsequently prescribed by the Federal Communications Commission. This is evident from the citation by the court below of the decision in *Arizona Grocery Company* v. *Atchison, Topeka and Santa Fe Rail-*

way Company, 284 U. S. 370. In that case the Interstate Commerce Commission, in making a reparation award, held a rate to be excessive which was in compliance with a previous Interstate Commerce Commission ruling issued when the charge in question was originally made. In setting aside the Commission's order, the question on which this Court there divided was whether the Commission was without authority thus to impose a liability upon a railroad for having made charges that the Commission had previously approved as reasonable. The Court made it clear, however, that the Interstate Commerce Commission would be authorized to change the rate in question for future purposes. No situation like that presented in the *Arizona Grocery* case is involved here. By its order initiating the investigation, the Commission exercising the authority conferred on it by Section 220 (c) of the Communications Act, called upon the appellee to justify the accounting entries questioned by the Commission. After determining the facts and considering appellee's attempted justification, the Commission by its order directed appellee to restate its accounts so that they would accurately reflect the transactions in issue. As a matter of fact, the order of investigation initiating the proceeding did direct inquiry into the question whether the appellee or any of its officials and directors had violated the Commission's account-

ing regulations. However, this portion of the proceedings was terminated and dismissed by the Commission's final order (R. 42). Thus it is clear that the Commission's order does not in any way attempt to penalize anyone for past action, but merely requires appellee to restate its accounts prospectively in accordance with the Commission's original cost system of accounts—an authority expressly recognized by this Court in the *American Telephone and Telegraph Company* case.

III

THE COMMISSION'S ORDER IS VALID EVEN THOUGH IT APPLIES, IN PART, TO ACCOUNTING WITH RESPECT TO PROPERTY WHICH HAS ALREADY BEEN RETIRED

In addition to the two grounds relied upon by the court below in setting aside the Commission's order, appellee argued below—although this was not incorporated in the court's opinion as a ground for the injunction—that since some of the property in question has been retired, the Commission's order improperly required the entire amount of the original write-up to be eliminated from its accounts. This contention completely ignores the fact that appellee's actual accounting in connection with the property in question has not eliminated any of the original inflation from its books and that appellee's books do not at the present time accurately reflect the facts as to the condition of the company.

As has already been pointed out (*supra*, pp. 9, 10–11), when appellee acquired the property in question it entered the entire amount of the so-called purchase price for the property in its plant accounts. No amount was entered in its depreciation or amortization reserves notwithstanding that, as can be seen from the table on page 9, *supra*, the property was carried on the A. T. & T. books before the transfer at a book cost of $13,269,567.47 with related depreciation and amortization reserves of $4,801,397.66 but was recorded in appellee's plant account at $12,634,680.38 with nothing in related depreciation and amortization reserves.

Thereafter, despite the fact that the acquired property was not new, and its "purchase price" purported to reflect all existing depreciation in the property, and despite the fact that no amount had been entered by appellee in its depreciation reserve at the time of the acquisition, appellee did not apply a special depreciation rate in order to accumulate in the reserve a sufficient amount to provide for the retirement of the book cost of the property at the end of its service life. Instead, appellee merely applied the current depreciation rates which it had previously established with respect to its various classes of plant. In the case of toll property, appellee already had property of this kind on its books; it recorded the acquired toll property in these accounts and used the pre-existing depreciation rates which were applicable

to such accounts (R. 26; Tr. 121–126, 362–366, 473). So far as the acquisition in 1927 of the instruments is concerned, appellee had had no property of this kind before 1927 and, on the assumption that the service life of the instruments was the same as that of other station equipment which it previously owned, the depreciation factor applied was that which appellee had previously established for such other station equipment based upon data through the year 1925[13] (R. 26; Tr. 548–554, 558–563, 1009–1010, 1018, 1022, 1036–1048, 1140–1141). As a result, when the property reached the end of its service life, insufficient amounts had been accumulated in appellee's depreciation reserve to cover the cost of the property as carried in appellee's plant accounts.

When the property in question was retired, appellee credited its entire book cost for that property to the plant accounts and the same amount (aside from the allowance for salvage) was debited to depreciation reserve. Thus, because of the type of accounting which was followed, appellee charged to the depreciation reserve more than had been credited thereto; the excess being at least as much as the amount of the

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[13] Depreciation rates are determined by estimating the total service life of property and the salvage which will remain at the end of service life. The annual depreciation rate is determined by dividing the service-life years into 100% (full book cost) minus salvage. For example, property with a 15-year service life and 10% salvage at the end of that time would carry a 6% annual depreciation rate.

original write-up with respect to that property.[14] The Commission concluded that this resulted in moving the inflation from the plant accounts to the depreciation reserve in the form of a defi-

[14] That this is so may be demonstrated by an example which, though simplified, accurately illustrates what happened in the instant case. Assume AT&T bought property at a cost of $80.00 which had an expected life of 10 years. The annual depreciation rate would hence be 10%, or $8.00 per year, assuming no salvage. If AT&T kept the property for 3 years and then transferred it to appellee for $70.00, the result would be a write-up of $14.00—the difference between $70.00 and $56.00, the net book cost of the property. Assume further that, as in the instant case, the property was recorded on appellee's books at $70.00 with nothing being recorded in the depreciation reserve, and that appellee continued to account for its depreciation at 10% of $70.00 each year. Upon the retirement of the property, only $49.00 would have been contributed to the depreciation reserve but $70.00 would have been credited to plant account and debited to depreciation reserve. Thus the deficiency in the depreciation reserve would be $21.00 or $7.00 more than the amount of the original write-up.

Similarly, in the instant case, when appellee recorded the transfers on its books at the so-called purchase price, a write-up of $4,166,510.57 resulted. Property with an original book cost of $13,269,567.47 and related depreciation and amortization reserves of $4,801,397.66 or a net book cost on the books of AT&T of $8,468,169.81 was entered in appellee's plant accounts at $12,634,680.38 with nothing entered in the depreciation or amortization reserves with respect thereto. The annual depreciation rates which appellee applied thereafter were those which had previously been determined with respect to the property of the class in question and were applied, moreover, to the 12 million rather than the 13 million figure. Thus, upon retirement of the property, none of the original write-up was removed from appellee's books.

ciency in the reserve. This conclusion is supported by testimony in the record of witnesses experienced in the field of regulation of public utility accounting (Tr. 1198–1199, 1891–1895, 1954, 1970–1973, 1986–1988; see also Tr. 1533–1534).

Appellee, in its argument before the Commission and the court below, attempted to answer this point on two grounds. In the first place, it contended that since much of the depreciation accounting followed by appellee occurred during a period before the Commission had jurisdiction over appellee's accounting, the Commission's order was an attempt retroactively to change its accounting. As has been pointed out under Point II, *supra*, the Commission has the authority to require appellee to conform its books to the Commission's System of Accounts even with respect to transactions that took place before the Commission was organized. The Commission's concern with the type of depreciation accounting followed by appellee in the past is not to require a retroactive change in depreciation rates but to show that because of the type of depreciation accounting followed by appellee, the amount of the original write-up was not removed from appellee's books as a result of the retirement of some of the property in question but presently remains in one of appellee's balance sheet accounts—depreciation reserve. If the accounting followed by appellee had left an excess in the plant account after the

retirement of property, a contention that the Commission could not require its elimination from the books would, of course, be given short shrift. A deficiency in the depreciation reserve stands on the same footing, since net book cost of property can as effectively be misstated by writing too much out of depreciation reserve as by writing too much into plant accounts.

Appellee's second argument is that it did in fact take into account the used life of the property in computing the depreciation rates for the acquired property. The record, however, amply supports the Commission's finding to the contrary. The appellee relies mainly on the testimony of one of its witnesses, Mr. Trax, who, in the course of his testimony (Tr. 365), made the general statement that consideration was given to the used character of the property but because of the fact "that there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from this purchase" no increase in the depreciation rate was deemed necessary. Mr. Trax did not elaborate on this statement and no studies or data were produced to show what "the other factors" were, how they were arrived at, or other like information. It is clear from Mr. Trax's testimony, however, that what he was referring to was his view that since the overall depreciation reserve was adequate, no added depreciation was necessary because as Mr. Trax

put it (Tr. 365) "the ruling consideration always was whether the total depreciation accrual for any given period was ample * * *."[15]

That this is the correct interpretation of Mr. Trax's statement appears also from the testimony of two other witnesses called by appellee, Mr. Bradshaw and Mr. Schaffer. Mr. Bradshaw, who was the telephone company official responsible for recording the transfers of toll properties on appellee's books, testified (Tr. 121-126) that the toll property acquired from A. T. & T. was recorded in the appropriate accounts on appellee's books and that the depreciation rate which appellee had theretofore developed for that type of property was used for the acquired property. He admitted that the depreciation rate had been determined before the transfers in question and purported to represent the total of straight line depreciation for that type of property. The witness conceded that in arriving at a depreciation rate representing total straight line depreciation, the total useful life of the property is used, but that, nevertheless, the rate so derived was applied to amounts pertaining to property acquired from A. T. & T., the remaining useful life of which, the witness admitted, was less than total useful life. Mr. Schaffer, a member of the accounting firm of Lybrand, Ross Bros. and Montgomery, testified (Tr. 478–479,

[15] As will be shown later on (*infra*, pp. 49–51), this position is completely untenable.

508–509, 1527, 1532–1534) that only if "precisely adequate rates of depreciation were used" would it be possible to have the plant and reserve accounts "relieved" upon retirement of the property. He admitted (Tr. 1532), however, that in considering the depreciation rates, he did not attempt to satisfy himself "whether the depreciation with respect to a particular piece of property was adequate or not. I think that we looked at the reserve as a whole * * *." Surely, in a proceeding where appellee had the burden of proof of justifying its accounting (see *supra*, p. 23) there can be no doubt that the Commission was justified in refusing to accept, as unpersuasive, appellee's suggested interpretation of the unsupported statement of Mr. Trax in the light of these clear admissions of Mr. Bradshaw and Mr. Schaffer.

The testimony in connection with the depreciation accounting for the telephone instruments similarly supports the Commission's finding. Appellee urged below that the depreciation rates applied to the telephone instruments took into account the fact that part of the useful life of the instruments had already been consumed when the instruments were transferred. But the testimony of appellee's own witness actually contradicts this contention. As has already been pointed out (*supra*, p. 11), the instruments were not transferred to plaintiff until 1927 but appellee's wit-

ness admitted (Tr. 1037–1038) that the depreciation rates which were thereafter applied were derived from a study of data pertaining to the other parts of the telephone stations through the year 1925—before the instruments were transferred.

It seems to be clear, from the emphasis by appellee before the Commission and in the court below and the testimony in the record on which it relies, that appellee's real argument on this point is not that depreciation rates which it applied were sufficient to dispose of the write-up but, rather, that the mere fact that it debited its depreciation reserve with more than it had credited thereto is not controlling unless it can be shown that the depreciation reserve as a whole is inadequate. This is certainly a novel doctrine. What appellee is urging is that when the Commission discovers that there is an error in an entry made by a carrier in its depreciation reserve account, the Commission is powerless to require the correction of this error unless it can find that the depreciation reserve as a whole is incorrect (R. 36). The composition of the depreciation reserve of a company whose operations are as extensive as those of appellee depends upon many complex and variable factors. If, as appellee apparently suggests, the Commission may correct accounting mistakes which it finds with respect to that depreciation reserve only after it examines or reex-

amines anew in every case the overall adequacy of the depreciation reserve, the Commission would be hamstrung in the effective exercise of its power to regulate accounting. Under appellee's theory, there would be nothing to prevent it from increasing its own surplus or from making appropriations for payment into the surplus of its parent company, merely by debiting depreciation reserve—all this without any control by the Commission unless the Commission could find that such action left the depreciation reserve as a whole impaired. This would make a mockery of regulatory accounting. Cf. *United States* v. *Wabash R. Co.,* 321 U. S. 403, 414. As the Commission pointed out in its Report (R. 36):

> A forgiveness of the 1925–1928 write-ups on the ground of their elimination by charges against the depreciation reserve would be the equivalent of permission to establish corporate surplus out of accruals charged to operating expenses by a company under the guise of depreciation. New York is actually here trying to justify a transfer from its depreciation reserve to the corporate surplus of its parent, A. T. & T. New York's further contention, stated above, is in effect a claim that it can make any improper entries which would reduce its depreciation reserve, and not be required to correct such entries unless a deficiency can be proved in the reserve as a whole. This amounts to a claim,

about which no more need be said, that no individual accounting entries can be ordered to be corrected unless the Commission can prove that all the accounts involved are otherwise in order.

CONCLUSION

All the contentions which the appellee now makes were urged by it before the Commission, which carefully considered and rejected them. As the Commission's report and the supporting evidence in the record show, the Commission's determination is reasonable and is therefore to be sustained. For, as Mr. Justice Cardozo, speaking for the Court, in the *American Telephone and Telegraph* case, pointed out (pp. 236–237):

> This court is not at liberty to substitute its own discretion for that of administrative officers who have kept within the bounds of their administrative powers. To show that these have been exceeded in the field of action here involved, it is not enough that the prescribed system of accounts shall appear to be unwise or burdensome or inferior to another. Error or unwisdom is not equivalent to abuse. What has been ordered must appear to be "so entirely at odds with fundamental principles of correct accounting" (*Kansas City Southern Ry Co.* v. *United States,* 231 U. S. 423, 444) as to be the expression of a whim rather than an exercise of judgment.

See also: *Interstate Commerce Commission* v. *Goodrich Transit Co.*, 224 U. S. 194; *Norfolk & Western Ry. Co.* v. *United States*, 287 U. S. 134; *Northwestern Electric Co.* v. *Federal Power Commission*, 321 U. S. 119; *New England Telephone and Telegraph Company* v. *United States*, 53 F. Supp. 400 (D. Mass.).

Accordingly, the court below should have granted the government's motion for summary judgment and should have dismissed the complaint. *National Broadcasting Company, Inc., et al.* v. *United States, et al.*, 319 U. S. 190. The judgment of the court below should, therefore, be reversed.

Respectfully submitted.

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OCTOBER 1945.

APPENDIX

The pertinent provisions of the Communications Act of 1934 (c. 652, 48 Stat. 1064, as amended, c. 229, 50 Stat. 189, 47 U. S. C. 151, *et seq.*) are as follows:

SEC. 220 (a). The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys.

SEC. 220 (c) The Commission shall at all times have access to and the right of inspection and examination of all accounts, records, and memoranda, including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by such carriers, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by such person. Any provision of law prohibiting the disclosure of the contents of messages or communications shall not be deemed to prohibit the disclosure of any matter in accordance with the provisions of this section.

SEC. 402 (a) The provisions of the Act of October 22, 1913 (38 Stat. 219), relating to the enforcing or setting aside of the orders of the Interstate Commerce Commission, are hereby made applicable to suits to enforce, enjoin, set aside, annul, or suspend any order of the Commission under this Act (except any order of the Commission granting or refusing an application for a construction permit for a radio station, or for a radio station license, or for renewal of an existing radio station license, or for modification of an existing radio station license, or suspending a radio operator's license), and such suits are hereby authorized to be brought as provided in that Act.

SEC. 604 (a) All orders, determinations, rules, regulations, permits, contracts, licenses, and privileges which have been issued, made, or granted by the Interstate Commerce Commission, the Federal Radio Commission, or the Postmaster General, under any provision of law repealed or amended by this Act or in the exercise of duties, powers, or functions transferred to the Commission by this Act, and which are in effect at the time this section takes effect, shall continue in effect until modified, terminated, superseded, or repealed by the Commission or by operation of law.

The pertinent provisions of the Rules and Regulations of the Federal Communications Commission (47 Code Fed. Reg. 31.01–1, *et seq.*) are as follows:

SEC. 31.01–3 (x) "Original cost" or "Cost," as applied to telephone plant, franchises, patent rights, and righ-of-way, means the actual money cost of (or the cur-

rent money value of any consideration other than money exchanged for) property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors.

SEC. 31.100:1 *Telephone plant in service.* This account shall include the original cost (note § 31.01–3 (x)) of the company's property used in telephone service at the date of the balance-sheet as classified under Accounts 201 to 277, inclusive. (Note also §§ 31.01–3 (gg), 31.2–20, 31.2–21.)

SEC. 31.100:2 *Telephone plant under construction.* (a) This account shall include the original cost (note § 31.01–3 (x)) of construction of telephone plant not completed ready for service at the date of the balance-sheet. It shall include interest during construction, taxes during construction, and all other elements of cost of such construction work. (Note also §§ 31.2–20 to 31.2–22.)

(b) When any telephone plant the cost of which has been included in this account is completed ready for service, the cost thereof shall be credited to this account and charged to the appropriate telephone plant or other accounts.

SEC. 31.100:3 *Property held for future telephone use.* (a) This account shall include the original cost (note § 31.01–3 (x)) of property owned and held for imminent use in telephone service under a definite plan for such use.

(b) The property included in this account shall be classified according to the primary accounts for telephone plant in service. Separate subaccounts shall be provided for this purpose which accounts shall carry the same numbers as the plant ac-

counts except that each account number shall be prefixed by (1). (Note also §§ 31.2–20, 31.2–21.)

SEC. 31.100:4 *Telephone plant acquisition adjustment.* (a) This account shall include amounts determined in accordance with § 31.2–21 representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost (note § 31.01–3 (x)) of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired. If the actual original cost is not known, the entries in this account shall be based upon an estimate of such cost.

(b) This account shall be subdivided according to the character of the amounts contained therein. In addition to a copy of the journal entry recorded to open the account, the company shall file with this Commission statements showing the basis of the computation of amounts included therein. The detailed records supporting these statements shall be retained permanently by the company.

(c) The amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct.

SEC. 31.172 *Amortization reserve.* (a) This account shall be credited with amounts concurrently charged to Account 613,

"Amortization of intangible property," for the amortization of leaseholds, franchises, and patent rights. (Note also § 31.2–25 (e).)

(b) This account shall be credited with any amounts concurrently charged to Account 413, "Miscellaneous debits to surplus," to provide a reserve for the retirement of amounts carried in Account 201, "Organization." It shall also be credited with any amounts which this Commission may authorize under a plan to amortize the balance in Account 100:4, "Telephone plant acquisition adjustment."

(c) When any leasehold carried in Account 211, "Land," or any franchise or patent expires, is relinquished, or otherwise retired from service, this account shall be charged with the amount previously credited hereto with respect to the property going out of service. The original cost (note § 31.01–3 (x)) of the property so retired less the amount chargeable to this account and less the proceeds realized at retirement shall be included in the appropriate surplus account. (Note Accounts 315 and 174 for depreciation of miscellaneous physical property.)

SEC. 31.413 *Miscellaneous debits to surplus.* This account shall include amounts chargeable to surplus not provided for elsewhere. Among the items which shall be charged to this account are (note § 31.01–8):

Amortization, at the company's option, of the balance in Account 201.

Amortization unprovided for elsewhere.

Amounts charged to surplus to cover past accrued depreciation not provided for. (Note also Account 171.)

Amount of the debit balance in the discount, premium, and debt expense account relating to long-term debt reacquired at the time of its reacquirement. (Note § 31.1–15.)

Amount of the debit balances in the discount and premium, and stock expense accounts relating to capital stock reacquired at the time of its reacquirement. (Note § 31.1–14, also Account 134: 2.)

Amounts charged to surplus to extinguish all or any part of the debit balance in any particular discount, premium, and debt expense account for long-term debt actually outstanding. (Note § 31.1–15.)

Amounts paid for abrogation of contracts.

Appropriations to nonpar stock account. (Note § 31.1–16: 1.)

Debits resulting from adjustments required to bring to par securities issued or assumed by the company and reacquired at a cost exceeding the par value. (Note also § 31.1–13.)

Delayed debits to income, operating revenue, and operating expense accounts as provided in § 31.01–5.

Expenses incurred in connection with the reacquisition of capital stock and long-term debt. (Note also § 31.1–13 (b).)

Forfeitures of amounts deposited under options for the purchase or lease of property.

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Losses resulting from the sale, destruction, or retirement of property carried in Account 103. (Note also Account 174.)

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SEC. 31.614 *Amortization of telephone plant acquisition adjustment.* This account shall be charged or credited each month with such amounts as may be authorized by the Commission to be included in operating expenses under a plan to amortize amounts in Account 100:4, "Telephone plant acquisition adjustment." Amounts so entered shall be charged or credited, as appropriate, to Account 172, "Amortization reserve."

U. S. GOVERNMENT PRINTING OFFICE: 1948

Supreme Court of the United States

October Term, 1945—No. 55.

UNITED STATES OF AMERICA and
FEDERAL COMMUNICATIONS COMMISSION,

Appellants,

v.

NEW YORK TELEPHONE COMPANY,

Appellee.

BRIEF FOR NEW YORK TELEPHONE COMPANY, APPELLEE.

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v.

New York Telephone Company,
Appellee.

BRIEF FOR NEW YORK TELEPHONE COMPANY, APPELLEE.

Opinion Below.

The opinion of the District Court for the Southern District of New York is reported in 56 F. Supp. 932 (1944).

Jurisdiction.

The jurisdiction of the District Court was invoked pursuant to Section 402(a) of the Communications Act of 1934, 48 Stat. 1064, 1093, 47 U. S. Code §402(a). This section makes applicable to orders of the Federal Communications Commission (other than orders relating to radio station construction permits or licenses or radio operators' licenses) the provisions of the Urgent Deficiencies Act, 38 Stat. 219, 220, 28 U. S. C. §§41(28), 43-48, inclusive, which vest the District Courts with jurisdiction to entertain suits to enjoin the enforcement of orders of the Interstate Commerce Commission. Accounting orders of the Interstate Com-

merce Commission and the Federal Communications Commission are final orders affecting substantial rights which are proper subjects of suits under these Acts.

> *Kansas City Southern Railway Co.* v. *United States*, 231 U. S. 423 (1913);
> *Norfolk & Western Railway Co.* v. *United States*, 287 U. S. 134 (1932);
> *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232 (1936).

The jurisdiction of this Court on appeal rests upon Section 238 of the Judicial Code, 28 U. S. C. §345(4), as affected by the above cited provisions of the Federal Communications Act.

Statement of the Case.

This case differs radically from any previous case arising in the application of "original cost" accounting to public utility companies which had theretofore kept their accounts on a different basis. Previous cases have dealt with attempts by regulatory commissions to require adjustments in the accounts for the purpose of showing certain facts with respect to assets still in service. Here, although three-quarters of the assets involved have already been retired and written out of the company's accounts, the Commission has sought, by requiring adjustments in the surplus and depreciation reserve accounts, to treat these retired properties, in effect, as if they still existed.

In its effort to justify this, the Government completely misstates appellee's position. Appellee has not questioned the Commission's power to prescribe a new System of Accounts different from that theretofore prescribed or to require a reclassification of existing balances to conform

thereto. Appellee has not contended that such a reclassification would be retroactive, nor has it claimed a vested right in any previously prescribed accounting rules or entries. Appellee's position has been consistent; it is the position of the Commission which has changed.

The Commission's Order was based entirely on a finding (see pp. 19-22, *infra*) that the entries upon the acquisition of the properties in the 1920's were *erroneous when made*,—whether because in violation of the I. C. C's rules then effective or of the F. C. C.'s views retroactively applied, is not clear. Any assertion of power in the F. C. C. to make retroactive rules is now disclaimed by the Government and the claim of violation of the I. C. C.'s rules is not seriously argued. Thus the basis of the Order—that the original entries were erroneous and that the entries now ordered are in correction of those errors—no longer stands.

The Government now seeks to defend the Order on the ground that the Order merely requires a reclassification of appellee's accounts under the "original cost" provisions of the Commission's new System of Accounts. It does this despite the facts that the Commission's report expressly denies that such is the case (R., p. 36), and that the Order is itself contrary to the terms of the new System and is otherwise wholly inappropriate as a reclassification.

The Government also seeks to defend the Order on a ground entirely unrelated either to transactions between affiliates, original cost accounting or the Commission's new System of Accounts. This is the claim that, as the result of an alleged failure to accrue sufficient amounts in the depreciation reserve to retire the purchased property, there is now a deficiency in the reserve "at least" as large as the transfer from surplus to depreciation reserve required by the Order. No such issue was tried before the Commis-

sion and there is no evidence to support the Government's claims.

The Government also denies the applicability of the "binding construction" in the *A. T. & T.* case, which we urge as an independent ground for enjoining the Order.

The statutory court was unanimously of the opinion that the Order could not be supported on any of the grounds urged by the Government, and that the case required further consideration by the Commission. The statutory court, of course, left the Commission entirely free, on further hearing, to require a proper reclassification of appellee's accounts under the Commission's "original cost" system.

The Facts.

The order of the Federal Communications Commission, the enforcement of which the District Court enjoined, directed the appellee, New York Telephone Company, to write off, by a charge to surplus, the sum of $4,166,510.57 (R., p. 41).* This was the amount by which the purchase price paid by the appellee for certain telephone plant purchased by it from American Telephone and Telegraph Company in the years 1925-1928 exceeded the amount

* This order is sometimes hereinafter referred to as "the Order". The Federal Communications Commission will be generally referred to as "the Commission" or "the F. C. C.", the Interstate Commerce Commission as "the I. C. C.", New York Telephone Company as "the New York Company" or as "the appellee", and American Telephone and Telegraph Company as "the American Company".

References to the printed record in this Court are indicated as (R., p. ....). The parties have stipulated (R., p. 136) that the transcript of the hearings and the exhibits before the F. C. C. need not be printed. References to this transcript and these exhibits, as paged in the F. C. C.'s motion for summary judgment in the court below, are indicated as (Tr., p. ......) or by the appropriate exhibit numbers. References to the Appendix to this brief will be indicated as (A., p. ..).

found by the F. C. C. to represent the net book cost* of such plant on the books of the American Company at the time of these purchases.

The F. C. C. directed this write-off in spite of the fact that, as found by the District Court (R., p. 129), the bulk of the property so purchased had already been retired and written off with a corresponding charge against depreciation reserve, so that, as of the effective date of the Order, only $3,241,865.52, or less than 26% of the property originally purchased, remained in the appellee's property accounts (R., pp. 128-129). In other words, the write-off directed by the F. C. C. exceeded, by nearly a million dollars, the entire amount at which the purchased property remaining in service was recorded on the appellee's books on the effective date of the Order.

The United States and the F. C. C. now make no claim of overvaluation of these properties, and do not seriously argue that there was error in the original accounting. However, so many different grounds have been asserted at different times as justification for the action here taken that we believe it will be helpful briefly to set forth the facts as to these purchases and the appellee's accounting for them.

1. The purchase of toll plant and instruments by the appellee from the American Company.

For many years prior to 1925, due to certain historical reasons, both the American Company and the appellee had been engaged in furnishing intrastate toll service within the State of New York (Tr., pp. 78-81, 309, 515-523).

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* The term "net book cost" is defined in the Commission's report (R., p. 24) and will be used in this brief to mean "the book cost minus the amount of depreciation and amortization reserves shown on the books which is related to the property for which the book cost is shown".

In order to eliminate this overlap, the American Company agreed to transfer all of its New York intrastate toll business to the appellee. This was accomplished in three transfers, as of June 1, 1925, November 1, 1925 and September 1, 1926 (R., p. 121; Tr., pp. 78-81).

To handle the additional intrastate toll business so transferred, the appellee required considerable amounts of toll property. This it had either to construct or to acquire from the American Company. It was to the obvious interest of both parties that the plant thus needed by the appellee be purchased from the American Company, and the two companies agreed that this should be done. The purchase of the toll property by the appellee was made as of November 1, 1925 and September 1, 1926, the latter purchase being comparatively small in amount. As of December 31, 1928, another small amount of toll plant was purchased by the appellee from the American Company to handle certain interstate toll business which had been transferred by the American Company to the appellee (R., p. 121; Tr., pp. 1273-1274).

The two companies agreed that the purchase price for this toll plant should be an amount equal to its "structural value." "Structural value" was a term of art defined in the I. C. C.'s Uniform System of Accounts for Telephone Companies (Instruction 13) as "the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy." The structural value of the toll plant was determined by means of a field inspection and detailed appraisal described at length at the hearing before the F. C. C. (R., p. 122; Tr., pp. 84-86, 91, 109, 323-357, 418, 569-615, 623-662, 666-675, 766-828, 832-931, 1240-1273, 1276; Exs. 1, 16, 21 and 44; Tr., pp. 2167, 1154, 1156, 574-575,

2183). The structural value so determined and the resulting purchase price appear in the fourth column of the table on page 9 of the Government's Brief.

From the earliest days of telephony, the American Company, as holder of the fundamental Bell patents, had owned three parts of the telephone apparatus, which the appellee and other licensee companies were authorized to use. These parts, the transmitter, receiver and induction coil, known collectively as "the instruments," are an integral part of the telephone equipment placed upon the premises of subscribers, the rest of which (such as the stand, the bell box and the casing) was owned by the various licensee companies. The use and maintenance of the instruments were included among the services furnished by the American Company under a license contract, for which the licensee companies made specified payments (R., pp. 121-122; Tr., pp. 212, 530).

On December 31, 1927 the American Company sold to the appellee the instruments then in the latter's service or supplies. The purchase price was $6,661,238.91. This price was based upon the average price charged the American Company by Western Electric Company, the manufacturer of the instruments, during the first nine months of 1927, less an allowance of 20% to reflect their then condition. It was approved by qualified engineers of the appellee, after investigation, as a fair and reasonable price (R., p. 122; Tr., pp. 965-967, 1034; Exs. 19, 48, 51; Tr., pp. 1106-1107, 1105-1106, 2184-2185). Similar sales of instruments were made at the same time and on the same basis to all of the licensee companies of the American Company, including companies which were not controlled by the American Company (Tr., pp. 989-990).

This appeal presents no question of overvaluation of the property purchased by the appellee from the American Company. On the contrary, as is set forth in Finding of Fact X of the court below, which is not challenged by the appellants, "the defendant Federal Communications Commission in the proceeding before it resulting in its order dated December 14, 1943, * * * made no determination with respect to the value of any of the property purchased by the plaintiff from the American Company and counsel for the defendants in this action, upon oral argument, informed the Court that the Commission was not relying on any claim of overvaluation and that for the purposes of this action no such issue existed" (R., p. 122).

2. The appellee's accounting for these purchases.

Although the Government now takes the position (Government Brief, p. 37) that it is immaterial whether appellee's original accounting for these purchases was or was not erroneous, this represents, as will be shown hereafter (pp. 19-22, *infra*), a complete departure from the basis on which the Order was founded. For that reason it becomes important for the Court to have before it the facts concerning this accounting.

At the time of these purchases the appellee's accounting was regulated by the I. C. C., pursuant to Section 20 of the Interstate Commerce Act (24 Stat. 379, 386, as amended by the Acts of June 29, 1906, 34 Stat. 584, 593, 594 and of June 18, 1910, 36 Stat. 539, 555). By order dated December 10, 1912, the I. C. C. had adopted a "Uniform System of Accounts for Telephone Companies, First Issue", effective January 1, 1913. This System of Accounts, with minor amendments not here material, remained in effect until January 1, 1933, when the I. C. C.'s "Uniform

System of Accounts for Telephone Companies, First Revised Issue'' became effective (R., p. 122).

The provisions of the Uniform System of Accounts for Telephone Companies, First Issue, relating to the recording of property purchased were contained in Instructions 10 and 13. Instruction 10, a general instruction relating to all acquisitions, so far as here material, read as follows (R., pp. 122-123; A., p. 4):

> ''10. *Costs to be actual money costs.*—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. * * *''

Instruction 13 contained special instructions as to the accounting ''when any property in the form of a going or completed plant is purchased.'' This instruction, so far as here material, read as follows (R., p. 125; A., pp. 4-5):

> ''13. *Plant and equipment and other property purchased.*—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired *should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy.* If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, 'Other Intangible Capital,' and the appraised value of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money

value of the consideration given was not in excess of such appraised value, such actual money value should be distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts. * * *" (Italics ours.)

In its Accounting Bulletin No. 11 issued June 26, 1916, the I. C. C. defined the scope of the transactions to which Instruction 13 applied, as follows (R., pp. 123-124):

"Case No. 30.

"Query. What items should be classified as 'going or completed plant' under section 13, page 33, 'Plant and equipment and other property purchased' of the Uniform System of Accounts for Class A and B companies?

"Answer. The term 'going or completed plant' is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—

"(1) A telephone company as a whole,

(2) An entire central office,

(3) A system of lines and stations within a given area, or

(4) A complete section of toll plant. * * *"

It is to be noted that none of these instructions drew any distinction between cases where the acquisition was from an affiliated company and cases where the acquisition was from a stranger.

The appellee's acquisitions of toll plant from the American Company clearly constituted the acquisition of "a complete section of toll plant" as set forth in subdivision (4) of Case No. 30 of the I. C. C.'s Accounting Bulletin No. 11. Accordingly, the accounting for these

purchases was governed by Instruction 13 of the I. C. C.'s Uniform System of Accounts which required that the property be recorded in the plant accounts at structural value determined by appraisal, not, however, in excess of the amount paid. Since the amount paid by the appellee for the toll plant was the appraised structural value of the plant, the purchase price of $5,973,441.47 was distributed, in accordance with Instruction 13, among the various plant accounts, such as pole lines, aerial wire, etc., in the precise amount of the appraised structural value of the various types of property purchased (R., p. 124; Tr., 115-116).

In accounting for the purchase of the instruments, the appellee again turned to Case No. 30 in Accounting Bulletin 11 to determine whether or not this transaction was subject to Instruction 13. It determined that the instruments did *not* comprise "the entire plant of a telephone company or an important unit thereof," to which alone, as set forth in Case No. 30, Instruction 13, with its requirement of appraisal, was applicable. The controlling instruction was therefore Instruction 10 which directed that charges should be made to fixed capital or other property accounts in the amount of the actual money cost of the property. The instruments were therefore recorded in the appropriate accounts at their actual money cost, to wit, $6,661,238.91 (R., p. 124; Tr., p. 483).

So much for the accounting performed at the time of the purchases. Now let us turn to the depreciation accounting subsequently performed.

This likewise was regulated by the I. C. C.'s accounting rules. The so-called "group method," which both the I. C. C. and later the F. C. C. itself prescribed for telephone company depreciation accounting, recognizes that it would be wholly impracticable for a company which employs a

Tr., pp. 1279-1301, 1421-1438, 1322, 2163, 2185). The District Court found that of the $12,634,680.38 of property originally purchased by the appellee from the American Company, only $3,241,865.52 remained in appellee's plant accounts on December 31, 1941 (R., pp. 128-129).*

3. The background and nature of this proceeding.

The Communications Act of 1934 vested in the F. C. C. the right (Sec. 220(a)) to "prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act . . ." The facts in regard to the Uniform System of Accounts embodying "original cost" accounting promulgated by the F. C. C. under this authority, the litigation culminating in the decision of this Court in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232 (1936), and the appellee's reclassification of its accounts, are sufficiently set forth in the Government's Brief (pp. 12-15).

That Brief (pp. 15-16) likewise sufficiently describes the proceedings before the Commission resulting in the Order here in question. As to the *basis* upon which the Commission founded the Order, however, we request the Court, for reasons which will hereafter appear (pp. 19-22, *infra*), to study the full text of the Commission's report (R., pp. 21-40) rather than the characterization of it on page 17 of the Government's brief.

Upon the coming down of the Order, the appellee brought this suit in the District Court for the Southern District of New York to enjoin its enforcement (R., pp.

* Fifty-seven per cent of the property purchased had been retired and written off even before January 1, 1937 (the effective date of the F. C. C.'s System of Accounts). Of the $12,634,680.38 of property included in the original purchase, only $5,404,164.40 remained in appellee's accounts at January 1, 1937 (Exs. 58, 62, 67; Tr., pp. 1322, 2163, 2185).

1-20). The appellants moved for summary judgment on the record made before the Commission (R., pp. 57-65), and it was agreed among counsel for the parties that upon the determination of this motion final judgment might be entered in favor of the party in whose favor said motion should be decided (R., p. 120).

On August 24, 1944, the District Court (Swan, C. J., and Clancy and Bright, D. J.) handed down its unanimous opinion (R., pp. 108-118) denying the appellants' motion for summary judgment. The District Court held that the accounting followed by the appellee at the time of and after the acquisition of the toll plant and instruments was in conformity with the rules of the I. C. C.; that the F. C. C. cannot apply a new system retroactively so that entries that were proper when made now become erroneous; and further that, under the administrative construction of the F. C. C.'s System of Accounts made by the Commission in the *A. T. & T.* case, the mere fact that property had been purchased by the appellee at a price in excess of the then net book cost of the American Company did not justify the F. C. C.'s now directing the appellee to write off the entire amount of such excess to surplus.

Pursuant to the above-mentioned agreement of counsel, final judgment permanently enjoining the enforcement of the Federal Communications Commission's order was entered by the District Court (R., pp. 118-119).

Outline of Argument.

The appellants, ignoring the settled rule that an administrative order cannot be upheld unless the grounds upon which the agency acted were those upon which its action can be sustained, seek in their Brief in this Court to justify the Order upon a basis entirely different from

that on which it was founded by the F. C. C. The F. C. C. based the Order, as we shall show, upon alleged errors in the original entries. This ground is now ignored and the Government seeks to defend the Order on entirely different grounds, the principal one of which, to wit, the claim that the Order is simply a reclassification under the F. C. C.'s System of "original cost" accounting, was directly repudiated in the F. C. C.'s report (R., p. 36).

The Government seeks to place the appellee in the position of contending that the F. C. C. had no authority to require a restatement of the accounts with respect to transactions which took place before the Commission was in existence, and of claiming (Government Brief, p. 38) a "vested right in the system of accounting which prevailed at the time a particular transaction took place." The appellee does not make and has never made any such contention.

On the other hand, this conceded premise that the F. C. C. is not precluded from requiring a reclassification of accounts simply because the transaction from which these accounts result was properly recorded under a previous accounting system, certainly does not lead to the conclusion that the F. C. C. can make any order with respect to such past transactions that it pleases. Specifically, this premise does not support a conclusion that when three-fourths of the property involved in a past transaction has already been retired and written off, the F. C. C. can require the same write-off as if all the property were still in existence. Neither does the premise support a conclusion that the F. C. C., by virtue of what the Government now calls a reclassification order, may require a telephone company to add to an admittedly adequate depreciation reserve an amount, in this case $3,879,957.94, actually larger than the cost of all of the property not already retired.

This gap between premise and conclusion, which the Government jumps so easily in its brief, did not seem so easy to the F. C. C.'s staff or to the F. C. C. itself. The F. C. C.'s staff realized that their desire to secure a write-off to surplus equal to the excess of the purchase price paid by the New York Company over the American Company's net book cost could not be fulfilled through a reclassification of the existing balances to conform with the F. C. C.'s System of Accounts since the *entire balance* remaining from the purchases was less than the desired write-off. They realized also that an attempt to construe the F. C. C.'s System of Accounts as requiring reclassification under "original cost" accounting with respect to *retired* property would be wholly irrational and would be inconsistent with the Government's own professions in the *A. T. & T.* case (see pp. 33-34, *infra*) that in applying the new system of "original cost" accounting "property retired since acquisition is not involved."

The theory which the F. C. C.'s staff developed to accomplish their purpose was that appellee's *original accounting* had been erroneous. On this view, the F. C. C. would not be requiring a "reclassification" under which it would meet the objection that the accounts could not be reclassified as to property already retired, but merely a "correction" which should have been made even if the F. C. C.'s System of Accounts had never taken effect.

The appellee countered with two contentions: *first*, that its original accounting was not erroneous and, *second*, that even if it were, such an error would not justify a correction in respect of property already removed from the books. The F. C. C. sustained its staff's contention that the original accounting was erroneous (R., pp. 28-29). Its report is not altogether clear as to whether it reached this result on the basis that the original accounting transgressed

the I. C. C.'s rules (R., pp. 32-34) or, as we think, on the ground that the original accounting violated the F. C. C.'s views retroactively applied (R., pp. 28-30); but that the Order was founded upon the premise that the original accounting was erroneous is clear beyond doubt. The Commission said unequivocally (R., p. 36) that "the entries made at the time of the four property transfers involved herein were improper" and that appellee "should have eliminated them and corrected its books *before reclassifying its accounts in 1937.*" (Italics supplied.) The Commission also rejected appellee's contention that if there had been an error in the original accounting, this error could be corrected only as to property still in existence. It made no attempt to sustain the Order as a reclassification, independent of the correctness of the original accounting.

In its brief in the District Court, and still more so in its brief in this Court, the Government has departed from this theory on which the F. C. C.'s Order was based. It says (Government Brief, p. 37) that a ruling by this Court on the question of compliance or non-compliance of the original accounting with the I. C. C.'s rules is not essential, and no question as to the correctness of the original entries is seriously pressed. Instead, the Government argues, *first,* that the Commission's order can be sustained as a reclassification under the "original cost" provisions of the Commission's Uniform System of Accounts (Government Brief, Point II), and, *second,* that, insofar as it goes beyond the proper scope of reclassification, it can be sustained as requiring rectification of a deficiency in appellee's depreciation reserve (Government Brief, Point III).

The Government's position must be rejected, *first,* because it is not the ground on which the Commission in fact proceeded and, *second,* because if the Commission had pro-

ceeded on this ground, its action would have been without warrant.

In Point I of this brief we will show that the District Court correctly set aside the Order because the Order cannot be sustained on the ground of error in the original accounting on which the Commission based it. The only lawful test of the correctness of the appellee's accounting for these purchases was whether or not it complied with the requirements laid down by the I. C. C. The District Court was plainly right in holding that the accounting did so comply. Since the Order cannot be sustained on the ground on which it was made, it is quite immaterial whether, as the Government now urges, the Order could be sustained on some other ground on which the F. C. C. did not in fact proceed.

In Point II of this brief we will deal with the entirely different theories upon which the Government seeks to sustain the Order in this Court, namely, that regardless of the propriety of the original accounting the F. C. C. may nevertheless, by virtue of its power to order a reclassification under "original cost" accounting of the balances existing on the effective date of its System of Accounts, or otherwise, require precisely the same write-off as it in fact required in pursuance of its theory of error in the original accounting. The Order cannot be sustained as a reclassification to an original cost basis, since this is not what the Order purports to be and since such a reclassification order, by its very nature, cannot deal with property already retired. Neither can the Order be sustained as requiring rectification of appellee's depreciation reserve, since no such issue was tried before the Commission, there is not the slightest evidence to support the Government's claims, and the Government's position involves a complete depar-

ture from the principles of depreciation accounting prescribed both by the I. C. C. and the F. C. C.

Finally, we shall show in Point III of this brief that the District Court would have been justified in enjoining enforcement of the Order upon the independent ground that it constitutes a flagrant violation of the "binding construction" of the F. C. C.'s Uniform System of Accounts which this Court demanded of the Government in the *A. T. & T.* case.

ARGUMENT.

POINT I.

The Commission's Order was properly enjoined for the reason that it was based upon the premise that the entries made at the time of acquisition of the properties were erroneous and this premise cannot be sustained.

A. The Order was founded upon the premise that appellee's entries made at the time of acquisition of the properties were erroneous.

In analyzing the F. C. C.'s report and Order, the Court should have clearly in mind the drastic nature of the action which the Commission's staff was urging it to take. The staff desired the Commission to direct the New York Company to charge its surplus with $4,166,510.57, and to increase its depreciation reserve by a credit of $3,879,957.94, in spite of the fact that, of the entire $12,634,680.38 of property purchased in the 1920's, only $3,241,865.52, or approximately one-fourth, remained upon the books of the New York Company as of the date when the Order was to take effect. Whatever write-offs might or might not have been ordered

in respect of this *surviving* property pursuant to the Commission's power to require the existing balances to be reclassified to an "original cost" basis under its System of Accounts, it must have been obvious that these relatively small remaining balances would not support charges to surplus or credits to depreciation reserve of any such magnitude as the F. C. C.'s staff was urging the Commission to direct.

It was in recognition of these difficulties, as well as in a desire to outflank the stipulation in the *A. T. & T.* case (see p. 57, *infra*), that the F. C. C.'s staff developed a theory *that would go back of the balances remaining on the appellee's books.* Their endeavor was to convince the Commission, as a basic premise, that the *original entries* for these purchases were erroneous. To be sure, once this was done it was also necessary to persuade the Commission, as a second step in the argument, that, in spite of the lapse of nearly twenty years and the depreciation and retirement accounting that had been carried on during them, the Commission might now direct substantially the same action as would have been appropriate to correct such an "error" if the "error" had been discovered immediately after the original entries had been made; and this claim was likewise sustained in the Commission's report (R., p. 35). However, the first step in the argument, namely, that the original entries were erroneous, was basic.

This claim of error in the entries made when the properties were first acquired dominated the entire proceedings before the F. C. C. Indeed, if this had *not* been regarded as the issue, the largest part of the testimony which the appellee was permitted to introduce and also of the tes-

timony offered by the Commission's staff would have been wholly irrelevant.*

Although the Government now makes very light of the question of the correctness or incorrectness of the original accounting, the Commission did not do so. The F. C. C.'s report makes it perfectly clear that its entire reasoning was predicated upon acceptance of its staff's contention that the original accounting was erroneous. The report states that "the accounting performed by New York with respect to the four property transfers involved herein was improper" (R., p. 28); that "the passage of time can lend no sanction to improper accounting" (R., p. 29); that "whenever errors in accounting are discovered they should be corrected" (R., p. 29); that the entries made by the appellee "should never have been recorded in New York's accounts" (R., p. 29); and that "since the entries made at the time of the four property transfers involved herein were improper New York should have eliminated them and corrected its books before reclassifying its accounts in 1937" (R., p. 36).

* For example, the appellee introduced testimony pursuant to specific permission of the F. C. C. (Tr., pp. 317-318) to show that it had accounted for the purchased property in accordance with Instructions 10 and 13 of the I. C. C. system of accounts (Tr., pp. 115, 116, 124, 84-86, 91, 109, 323-357, 418, 569-615, 623-662, 666-675, 766-828, 832-931, 1240-1273, 1276, 965-967, 1034, Exs. 1, 16, 19, 21, 44, 48, 51, Tr., pp. 1106-1107, 1105-1106, 2184-2185). The F. C. C. countered with extensive evidence intended to prove the contrary (Tr., pp. 680-714, Exs. 26-39, Tr., pp. 690-706, 1178-1224, 1613-1619, Exs. 71-78, Tr., pp. 1615, 1618, 1619, 1188-1198, 1603-1613, 1165-1178). The Commission also adduced testimony on the issue of whether the entries originally made by the appellee were consistent with fundamental principles of accounting outside of the prescribed I. C. C.'s system of accounts (Tr., pp. 1590-1603, 1624-1711, 1716-1734, 1772-1784, 1603-1623, 1165-1178, 1554-1590, 1933-1957, 1958-1990, 1990-2007, 2012-2017, 2022-2136). The appellee introduced rebuttal testimony both as to the I. C. C. rules and as to the fundamental principles of accounting generally accepted at the time of the purchases in question (Tr., pp. 445-465, 1345-1382, 725-755, 1711-1715, 1438-1481, Exs. 39-43, Tr., pp. 690, 706).

The Commission placed the basis of its action beyond all possible doubt when it stated that (R., p. 36):

> "The part played by the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder, was simply to call attention to an impropriety in accounts which should have been corrected *even if the new system had not gone into effect.*" (Italics supplied.)

We will now show that this basic premise of the Commission's reasoning was unfounded.

B. The F. C. C.'s proposition of error in the entries made at the time of acquisition of the properties cannot be sustained.

In our brief in the lower court we showed in some detail that the proposition of error in the original entries upon which the F. C. C.'s Order was premised could not be sustained. Since the Government now makes no substantial contention to the contrary, it is unnecessary to burden the Court with extended argument upon this issue. However, in view of certain innuendoes in the Government's Brief and the fact that the Government's fifth assignment of error (R., p. 132)* has not been formally abandoned, a few words must be said in order to make the position entirely clear.

While the F. C. C. clearly based its report upon the premise of error in the original accounting, it seemed to assert at the same time that it could determine the correctness of that accounting upon the basis of its own views retroactively applied and without reference to the I. C. C.'s

* This assignment is that "the Court erred in its determination that the accounting entries here involved were made in compliance with then applicable rules and regulations of the Interstate Commerce Commission."

accounting rules in effect when the entries were made. We urged the lower court that if this was the correct reading of the report, the Order must be set aside on that ground alone, since under the doctrine of *Arizona Grocery Co.* v. *Atchison, Topeka & Santa Fe Ry. Co.*, 284 U. S. 370 (1932), the I. C. C.'s rules constituted the only lawful standard for determining the propriety of appellee's conduct at the time. The occasion for the lower court's citation of the *Arizona Grocery Company* case, which the Government (pp. 39-41) now professes such difficulty in understanding, was, of course, this fact that while the F. C. C. rested its action upon the basis of the alleged unlawfulness of appellee's past conduct, it refused at the same time to judge the lawfulness of that conduct solely by the rules then in effect.

We showed alternatively in our presentation in the District Court that the appellee's accounting for these transactions conformed with the I. C. C.'s accounting rules. That appellee's accounting conformed with the language of these accounting rules appears sufficiently from what has appeared in our statement of the facts (pp. 8-11, *supra*). Any contention that these rules should be read as inapplicable to transactions between affiliates flies in the face of the general and comprehensive language used by the I. C. C. in regulating an industry where a very large proportion of the total transactions was well known to be between affiliates. Moreover, if the proper interpretation of these rules were doubtful in the slightest degree, which it is not, the history of the I. C. C.'s accounting rules and its *rejection* of "original cost" accounting shows conclusively that the rules meant exactly what they said.

The I. C. C.'s Uniform System of Accounts for Telephone Companies, as issued in 1912, following the

precedent of its accounts for railroads,* based its requirements for acquisition accounting upon cost to the accounting company.** The whole concept of "original cost" accounting not only was utterly foreign to the I. C. C.'s System of Accounts but was specifically rejected by the I. C. C., and this in the case of acquisitions from affiliated companies as well as in the case of acquisitions from independent companies.

Although the I. C. C.'s System of Accounts was promulgated in 1912, the entire theory of requiring a public utility to record, not its own costs of acquisition, but the net costs appearing on the books of a vendor, was not even advocated until the 1920's, and was not widely held until the early 1930's. It was then repeatedly urged upon the I. C. C. by various state commissions, but the I. C. C. declined to adopt it (Tr., pp. 1557-1559, 1658, 1977-1978, 1933).*** When the I. C. C. revised its Uniform System of Accounts for Telephone Companies effective January 1, 1933, it reaffirmed its adherence to the principle of cost to the accounting com-

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* See Interstate Commerce Commission Classification of Expenditures for Road and Equipment, First Revised Issue, effective July 1, 1907, and supplement effective July 1, 1908.

** In *Depreciation Charges of Telephone Companies*, 177 I. C. C. 351, 376 (1931), the I. C. C. said:

> "A general principle which has been followed in our classifications is that units of physical property shall be stated in the investment account *at cost to the accounting carrier.*" (Italics ours.)

*** The testimony of Mr. M. F. Orton, Director of Research and Valuation of the New York Public Service Commission, on this point merits quotation (Tr., p. 1978):

> "Q. What were the efforts to do? A. To have the Interstate Commerce Commission adopt a system which would reflect the original cost, in the case of all property, *whether acquired from related interests or at arms-length.*
>
> "Q. There were continued efforts to do that? A. Starting in 1930.
>
> "Q. And the Interstate Commerce Commission refused to do that? A. That is correct." (Italics supplied.)

pany—again without distinction between acquisitions from affiliated companies and acquisitions from others than affiliates (A., pp. 7-8).

To be sure, the I. C. C. realized that this general principle of cost to the accounting company required supplementation to prevent the recording of excessive or "inflated" amounts in the plant accounts. For that reason when it promulgated its System of Accounts in 1912, it provided for the segregation of the cost of telephone plant *in excess of the physical value.* Instruction 13 (*supra*, pp. 9-10) specified that, on any purchase of property "in the form of a going or completed plant," an appraisal must be made and any excess of purchase price over appraisal must be recorded in account 204, "Other Intangible Capital," against which no depreciation charges were permitted. In other words, the I. C. C.'s concern was not with excess of cost to the accounting company over *net book cost to the vendor,* which it regarded as irrelevant, but with excess of cost to the accounting company over *structural value at the date of acquisition.* This structural value safeguard was as applicable to a purchase from an affiliated company as to a purchase from a company not so affiliated.

In *Accounting Rules for Telephone Companies,* 203 I. C. C. 13, 43 (1934), the I. C. C. rejected a recommendation of the state commissions that its Uniform System of Accounts for Telephone Companies, First Revised Issue, should provide that, in all purchases of property previously used in telephone service, the property should be entered in the plant accounts on the basis of original cost to the company first devoting the property to the public service. It did this *specifically on the ground that changes in the price of capital assets due to changes in the price level ought to be recognized in the plant accounts and not eliminated from them as the state commissions urged.* It said (at page 43):

"While other considerations may affect the price to be paid for telephone plant purchased, it is fair to assume that the parties would have in mind as one of the elements the residual value of the various items *stated in terms of the current price level.* At any rate that is what the vendor parts with and what the vendee acquires so far as tangibles are concerned." (Italics supplied)

Our presentation on this subject in the lower court must have been convincing even to the Government, for in its brief in the District Court, while making a polite bow in the direction of the F. C. C.'s theory of error in the original accounting, the Government placed its principal reliance on other grounds. In its brief in this Court the Government does not seriously challenge the finding of the District Court that:

"The accounting entries made by plaintiff with respect to the toll plant and instruments purchased by it from the American Company from the time of their acquisition until January 1, 1937 were made in conformity with the rules which had been prescribed by the Interstate Commerce Commission and which were in effect during that period." (R., p. 129)

It says merely (Government Brief, p. 37) that it "does not consider a ruling on this point essential to the proper disposition of the case."*

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* Although the Government does not contend that the accounting was otherwise than in conformity with the I. C. C.'s rules, it does state (Government Brief, p. 36) that:

"The accounting for the specific transactions in question, however, was never submitted to the Interstate Commerce Commission for ruling, nor was any ruling ever made by the Interstate Commerce Commission with respect to the accounting therefor."

Since the accounting was clearly in accordance with formally promulgated rules of the I. C. C., there was no more occasion to submit

C. Since the proposition of error in the entries made at the time of acquisition of the properties cannot be sustained, the Order was properly enjoined.

We therefore think the Government was right when it decided to make no attempt to argue in this Court that appellee's original accounting entries were erroneous. But it is wrong when it takes the position that although the original accounting was correct, the Order can nevertheless be sustained. For an administrative order, as distinguished from a determination of a lower court, "can-

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these transactions for a ruling than any one of hundreds of others. Moreover, (1) these transactions were reflected in the annual reports filed both by the American Company and the New York Company with the Commission (Exs. 71-78, Tr., pp. 1615, 1618, 1619); (2) purchases of instruments similar to that made by the New York Company were made at the same time and on the same basis by all licensees of the American Company throughout the country, a transaction which naturally attracted wide attention on the part of persons dealing with telephony (Tr., pp. 989-990); and (3) both the instrument and toll plant transactions were specifically brought to the I. C. C.'s attention by Dr. M. R. Maltbie (Chairman of the New York Public Service Commission since 1931) in support of his argument for the adoption of original cost accounting by the I. C. C. in *Depreciation Charges of Telephone Companies* (1928), and *Accounting Rules for Telephone Companies* (1933), I. C. C. Dockets 14,700 and 25,705 (Tr., pp. 1992-1993, and Ex. 68 *id.*, Tr., pp. 1482, 1487, 2186).

Reference is also made in a footnote on pages 36-37 of the Government's Brief to various requests made by Bell System companies of the I. C. C. in cases where *the vendor's net book cost was the consideration actually paid*, for "rulings that it was proper to account for acquisitions of the type involved here by transferring the book figures of the transferor to the books of the transferee". The request was not for permission to record the acquisition upon any basis other than cost to the accounting company but simply for exemption from the necessity of obtaining an appraisal. The very fact that *permission* was deemed necessary to handle the transaction on the basis of the vendor's net book cost, even when this was the purchase price, is the plainest indication that the rules did not *require* the transaction to be so handled. Indeed, the I. C. C. specifically declined to issue any "general order" allowing any deviation from the requirement of appraisal and determination of structural value (Ex. 31; Tr., pp. 690, 706).

not be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained." *Securities and Exchange Commission v. Chenery Corp.*, 318 U. S. 80, 95 (1943). See, to the same effect, *Commissioner v. Heininger*, 320 U. S. 467 (1943), and *Eastern-Central Motor Carriers Association v. United States*, 321 U. S. 194 (1944).

As shown above (pp. 19-22), the Commission, for reasons which seemed compelling to it, placed its action squarely upon the ground of error in the original accounting. It went so far as to say (R., p. 36) that

> "Since the entries made at the time of the four property transfers involved herein were improper, New York should have eliminated them and corrected its books before reclassifying its accounts in 1937. The part played by the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder, was simply to call attention to an impropriety in accounts which should have been corrected even if the new system had not gone into effect."

In the face of this clear language of the Commission, it is simply impossible to sustain the Order, as the Government now seeks to do, as one properly made *under* "the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder," and *regardless* of the question of error or lack of error in the original accounting.

The Government will doubtless point to certain remarks in the F. C. C.'s report from which it may be argued that the Commission would have reached the same result if it had not reasoned from the erroneous premise that the original accounting was wrong. This is not enough. When an administrative agency has founded its determination on a basis on

which it cannot lawfully proceed, its order cannot be sustained on the basis of inferences, sought to be spelled out from passages in its report, that perhaps it might have reached the same result on other grounds. The statement by Mr. Justice Cardozo in *United States* v. *Chicago, Milwaukee, St. Paul & Pacific R. Co.*, 294 U. S. 499, 510 (1935), is applicable here:

> "We would not be understood as saying that there do not lurk in this report phrases or sentences suggestive of a different meaning. * * * The difficulty is that it [the Interstate Commerce Commission] has not said so with the simplicity and clearness through which a halting impression ripens into reasonable certitude. In the end we are left to spell out, to argue, to choose between conflicting inferences. Something more precise is requisite in the quasi-jurisdictional findings of an administrative agency. *Beaumont, S. L. & W. Ry. Co.* v. *United States*, 282 U. S. 74, 86; *Florida* v. *United States*, 282 U. S. 194, 215. We must know what a decision means before the duty becomes ours to say whether it is right or wrong."

See also *Connecticut Light & Power Co.* v. *Federal Power Commission*, 324 U. S. 515, 532-35 (1945).

If the original entries were correct, as they are now practically conceded to be, it is not simply to be *assumed* that the F. C. C., in the exercise of its power to require reclassification to accord with its new Uniform System of Accounts, would have ordered the appellee to make precisely the same charge to surplus as it in fact directed on the basis of an erroneous belief that the entries regarding these acquisitions were wrong in their inception, and on the theory that its "new Uniform System of Accounts . . ., and the reclassification requirements thereunder" were in no

way involved. The question of what changes the F. C. C. would direct in appellee's accounts, once it has been definitively ruled that appellee's original accounting was not erroneous, is a question that it and only it can determine. That question cannot be determined for it by Government counsel, or even by this Court.

POINT II.

Even if the Government might be heard to support the Commission's Order on grounds different from those upon which the Order was based, the Order cannot be sustained.

The Government's contention in this Court is that even though the original accounting was proper under the accounting rules applicable at the time, the Order can nevertheless be sustained as an exercise of the Commission's power to require the *balances* existing in the various accounts to be reclassified in conformity with the new System of Accounts prescribed by it. We will now show that even if the Commission's report could be read as based upon any such ground as this, the Order cannot be sustained.

We wish to emphasize at the outset that, whatever inferences to the contrary might be drawn from Point II of the Government's Brief, the appellee has never claimed and does not now claim any vested right in any of its book entries. We do *not* argue that because accounting was properly carried on under applicable regulation, the balances resulting from such accounting must remain in the same form to the end of time. We do *not* claim that simply because the I. C. C. permitted an excess of the purchase price of property over the seller's cost to be recorded in the plant accounts, the F. C. C. must allow it to remain there.

We concede that either the I. C. C. or the F. C. C. as its successor could require the balances remaining in appellee's property accounts to be reclassified to conform to a new system promulgated in accordance with law. Such a reclassification must, however, be a real reclassification in the light of the facts and of the actual rules of the new system.

That is all that the F. C. C. has been given power to do. Its authority under the Communications Act of 1934 is, *first,* to prescribe a system of accounts (§ 220(a)), *second,* to alter any such system on at least six months' notice, and; *third,* to police the system of accounts so prescribed (§ 220(g)). In other words, while Congress gave the Commission full and complete authority to enforce any system of accounts which the Commission lawfully prescribed, it did not empower the Commission to require revisions in past accounting *simply as such.*

In Point II of its Brief, the Government seeks to sustain the Order on the ground that it "merely requires appellee to restate its accounts prospectively in accordance with the Commission's original cost system of accounts" (Government Brief, p. 41). Apart from the point already made, namely, that this was not the basis on which the F. C. C. in fact proceeded, the answer to this contention is that this is not what the Order purports to do. For it applies not only to property still in appellee's property accounts, the only proper subject for reclassification under "original cost" accounting, but to property long since retired. In order to show that the F. C. C. had authority to make not merely *some* order but *this* order, the Government is thus forced to rely upon a further contention set forth in Point III of its brief, namely, that, insofar as the Order goes beyond a reclassification of existing balances in

the property accounts, it may be sustained as requiring rectification of a deficiency in the appellee's depreciation reserve.

The Order cannot be sustained on either of these grounds. It cannot be sustained on the ground urged in Point II of the Government's Brief, as requiring a reclassification of the balances in appellee's accounts to conform to the "original cost" provisions of the F. C. C.'s System, because it does not purport to be such an order and is not appropriate to that end. And it cannot be sustained on the ground advanced in Point III of the Brief, as requiring a rectification of appellee's depreciation reserve, because no issue as to the adequacy of the reserve was tendered by the order initiating the proceeding and there is no evidence to show any need for such rectification.

A. The Order cannot be sustained as a reclassification under the original cost provisions of the F. C. C.'s System of Accounts of the balances existing on the effective date of that System, since its provisions are not appropriate to that end.

A reclassification of the appellee's accounts to bring them into conformity with the F. C. C.'s principle of "original cost" accounting is necessarily limited to the balances existing in the various property accounts at the date as of which the proposed reclassification is made. The entire purpose of "original cost" accounting is to show the cost of the property now in public service at the time when it was first dedicated to that end, and to show separately the sums by which the price paid by the present owner for such property exceeded that original cost less the reserve requirements of the accounting company. This purpose is carried out by requiring the company to record

in one account (under the F. C. C.'s System, Account 100:1, *Telephone Plant in Service*) "the original cost [at the date of initial dedication to the public use] of the company's property used in telephone service at the date of the balance sheet * * *," and in a separate account (under the F. C. C.'s System, Account 100:4, *Telephone Plant Acquisition Adjustment*), the difference between the amount of money actually paid by the accounting company for such plant and the original cost of the property when first dedicated to the public use "less the amounts of reserve requirements for depreciation and amortization of the property acquired." It is obviously impossible to require the recording in the investment Account 100:4 of amounts paid in respect of property which, having been retired, is no longer an investment at all.

The F. C. C. is clearly on record to the effect that a reclassification to an "original cost" basis must necessarily be confined to property still on the books of the accounting company.

It stated in its brief in this Court in the *A. T. & T.* case (pp. 28-29) that the effect of its new System was merely to require "that the total amount in Account 100 of the present System* as of the effective date of the new system of accounts, shall be analyzed and then reclassified in the four new investment accounts as above numbered and named." ~~And in its reply brief in the *A. T. & T.* case before~~ the District Court (p. 88), it said:

> "Let us make the point clear that it is the original cost of that property *now used in telephone service, and of that property only* which it is necessary to

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* The instructions for this account, entitled "Telephone plant", provided:

> "This account shall include the company's investment in property used or held under a definite plan for telephone service * * *."

determine and record. Property retired since acquisition is not involved." [Italics in original.]*

As against this, the F. C. C.'s Order in this case was in no sense designed to compel appellee to determine "the original cost of that property now used in telephone service." Instead it represented an attempt by the F. C. C. to reach back of "the effective date of the new system of accounts" and to revise *ab initio* the entire accounting for all of the property acquired by the appellee from the American Company, including "property retired since acquisition."

In view of the F. C. C.'s own statement already quoted (p. 28, *supra*) that the only part played by its System of Accounts and the reclassification requirements thereunder was "to call attention to an impropriety in accounts which should have been corrected even if the new system had not gone into effect," it is unnecessary to indulge in extended argument to show that the F. C. C.'s order did not purport to be and was not one reclassifying the balances in appellee's accounts. However, if the F. C. C.'s report permitted any doubt upon this point, which it does not, that doubt would be completely dispelled by contrasting what would have been the approach if the F. C. C. had really been reviewing the reclassification of accounts made by the appellee subsequent to this Court's decision in the *A. T. & T.* case, with what the F. C. C. actually did.

In making its reclassification with respect to the toll plant, the appellee first ascertained the book cost of such of the plant as remained in service on January 1, 1937. This it determined to be $2,971,058.99. It then ascertained that the book cost of this same remaining property to the Ameri-

* The hearing Commissioner declined even to permit these briefs to be marked for identification (Tr., pp. 2189-2190).

can Company had been $2,487,083.16. It entered this latter sum in Account 100:1, *Telephone plant in service*, and recorded the $483,975.83, which represented the difference between the two sums in Account 100:4, *Telephone plant acquisition adjustment.* The appellee made no similar reclassification with respect to the instruments, for the reason that these were not deemed to constitute "a substantially complete telephone system, exchange, or toll line" within the meaning of §31.2-21 of the F. C. C.'s Uniform System of Accounts defining the category of acquisitions as to which the original cost method of accounting was made applicable.

If the F. C. C. had in fact been proceeding in the manner now claimed, it would have found that as to the toll plant, while the entry in Account 100:1, *Telephone plant in service*, correctly stated the book cost to the American Company of the plant remaining in service on January 1, 1937, there was a basis for a claim on its part that the amount entered by the appellee in Account 100:4, *Telephone plant acquisition adjustment*, was inadequate due to the failure to make any entry in Account 171, *Depreciation reserve*. If the F. C. C. had been proceeding along the lines now alleged, it might therefore have taken the position (indicated in the footnote on p. 14 of the Government's Brief) that the restatement of the accounts should have given recognition to "reserve rquirements" for the toll plant surviving as at January 1, 1937. On this view it might have determined appellee's reserve requirement and ordered a credit to Account 171, *Depreciation reserve*, in the amount so determined, with a corresponding increase in the amount to be recorded with respect to the surviving plant in Account 100:4, *Telephone plant acquisition adjustment*. Similarly, with respect to the instruments, if the appellee was wrong

in thinking that these did not constitute "a substantially complete telephone system, exchange, or toll line" within the meaning of the F. C. C.'s System of Accounts, the F. C. C., had it been proceeding on the basis now claimed, might have directed reclassification along similar lines of the balances as to the instruments remaining in service. In either case the Order would necessarily have been limited to the property still surviving.

If the F. C. C. had really been seeking to require a reclassification to conform with its own System of Accounts, its order would have differed from that actually made not only in this vital respect of being limited to surviving property but in another important respect as well.

The amount which the F. C. C.'s System of Accounts requires to be recorded in Account 100:4 is the difference between the amount of money actually paid for telephone plant and the cost of such plant to the original owner "less the amounts of reserve requirements for depreciation and amortization of the property acquired" (Instruction 31.100:4). The "reserve requirement" under straight-line depreciation accounting is the amount which should be in the reserve at a given time so that, when added to continuing accruals on the basis of the life and salvage then estimated, it will, if that life and salvage are exactly realized, equal the cost of the property less salvage at the end of its life.*

* Reserve requirement has been defined by the New York Public Service Commission (1939 Report, Vol. 1, p. 96) as being "the amount which should be in the reserve at a certain time in order that the continued application of the annual rates upon which the reserve was based would produce complete amortization of the cost within the remaining life of the property. In other words, it is the amount that should be in the reserve if straight line depreciation were correctly followed in all respects and if current anticipated life expectancies are realized."

The reserve requirements of the accounting company will, of course, vary from time to time, depending not only upon the age of the property but also upon current estimates as to length of its service life. These reserve requirements may be much greater or much less than the amounts set up for depreciation reserve on the books of the original owner at the time of sale. If the F. C. C. had any idea that it was requiring a reclassification under its own System of Accounts, it would scarcely have disregarded that System to the extent of basing its actions, not upon the reserve *requirements* of the accounting company at the date of the reclassification, as the System specified, but upon the actual *reserve* of the vendor at the time of sale.

Whatever results might have followed if the F. C. C. had proceeded to require a reclassification under its System of Accounts, it is thus clear that they would not have borne the slightest resemblance to what the F. C. C. has in fact ordered. With only an aggregate amount of $3,241,865.52 of the property purchased from the American Company (26% of the original total) remaining in the appellee's plant accounts as of December 31, 1941, the effective date of the Order, it would have been manifestly impossible for the F. C. C. to require entries *with respect to that property* which would have had the effect of placing in the adjustment account, 100:4, anything nearly as much as the $4,166,510.57 which it ordered appellee to charge to surplus. Certainly the Government cannot take the position that the credit of $3,879,957.94 to depreciation reserve, which the F. C. C. required as of that date, was needed to provide for the retirement of the actually *smaller* amount of property which was all that remained in the appellee's plant accounts.

The argument as to reclassification in Point II of the Government's Brief therefore does not show at all that the

Commission had power to make *this* Order. It shows merely that the Commission had power to make *an* order, and one very different from the order actually made.

B. The Order cannot be sustained as requiring rectification of an alleged deficiency in appellee's depreciation reserve.

To sustain the Order which the F. C. C. actually made, in contrast to a different one which it might have made, the sole remaining point advanced by the Government is (Point III of its Brief) that the F. C. C. was correcting a deficiency in the appellee's *depreciation reserve*. The claim is that the amounts which the appellee charged to depreciation were necessarily insufficient to provide for the retirement of the properties purchased from the American Company, and that, to the extent that the Order exceeds the limits permissible for an order reclassifying the balances in appellee's property accounts, it can be justified as requiring rectification of a deficiency in appellee's depreciation reserve.

The Government is totally unjustified in assuming, as it apparently does when it arrives at this point in its brief, that its case is won unless the appellee has some further arguments to advance. Except for an attempt in Point I of its brief to deal with appellee's contention with respect to the *A. T. & T.* case which is hereafter discussed (*infra*, pp. 54-60), all that has happened by the time the Government has reached Point III is that it has in effect confessed error with respect to the ground on which the F. C. C. actually based its Order, and has stated the conceded fact that the F. C. C. may require reclassification under its own System of Accounts of balances relating to property acquired in a transaction properly accounted for under a previous system. It has not answered and cannot answer

the demonstration just made that by its very nature the Order cannot be and does not purport to be such a reclassification. When we reach the Government's Point III, the basis on which the F. C. C.'s Order was made has been destroyed by the Government itself, and, quite apart from the doctrine of the *Chenery* case, *supra*, pp. 27-28, no other basis has been supplied to take its place. The contention as to depreciation accruals in Point III of the Government's Brief thus becomes the sole basis on which the Government's attempt to support the Order can rest.

This contention, of course, represents a complete departure from the claim of error in the original accounting, which constituted the basis of the order to show cause initiating this proceeding, of the entire hearing, and of the F. C. C.'s report. It has nothing whatever to do with the question of the purchase of property from an affiliate at more than the latter's net book cost. It equally has nothing to do with any question as to violation of the I. C. C.'s accounting rules. The issue has been transformed into one of proper depreciation accounting.

The new contention, as set forth in the Government's Brief (pp. 21-22, 41-51), is a purely theoretical one. It is a beautifully simple contention, as contentions unrelated to the facts usually are. It runs as follows: Part of the useful life of the property acquired by the appellee from the American Company had expired at the time of its acquisition. In spite of this, the appellee did not provide special (and higher) depreciation rates for this property but applied the same rates which it used for other property in the same class. This failure to provide special depreciation rates and the fact that the base on which accruals were made was not the original cost of the property but the amount paid by appellee to the American Company,

which was a price net after allowance for depreciation,* necessarily result, claims the Government, in a deficiency in appellee's depreciation reserve at least as great as the amounts by which the Commission's order requires the appellee to increase its depreciation reserve.

A brief outline of the nature and purpose of telephone company depreciation accounting, as this has been prescribed both by the I. C. C. and by the F. C. C., is itself sufficient to reveal the fallacies in the Government's argument. Instruction 23 of the I. C. C.'s Uniform System of Accounts, which in substance is continued in Instruction 31.02-80 of the F. C. C.'s Uniform System, prescribes that "the rate of depreciation should be fixed so as to distribute, as nearly as may be, evenly throughout the life of the depreciating property . . . . the cost of capital consumed in operations during a given month or year, and should be based upon the average life of the units comprised in the respective classes of property."

It must be obvious, in the first place, that "the average life of the units comprised in the respective classes of property" is a matter of judgment on which mathematical certainty is impossible. In the case of any company the charges made for depreciation and the resulting credits to the depreciation reserve are the results of many estimates of future life and future salvage. It is quite inconceivable that every one of these estimates should be precisely correct. Future events which affect the life of property cannot be exactly foreseen. One type of property will remain in service for a longer period than estimated, whereas the estimate made in the case of another type will prove too optimistic. This process of offsetting "one error by

* This, of course, was required by the I. C. C. rules. See A., pp. 4-6.

another," at which the Commission and the Government profess to be shocked (R., p. 36; Government Brief, p. 49), is fundamental in depreciation accounting.

Secondly, it must be understood that the judgments which lie at the basis of a telephone company's depreciation rates are frequently revised. Depreciation rates are the subject of constant studies by the management, which take all relevant factors into account. These factors include not only the presence within the group of items acquired when a portion of their service life had already expired (Ex. 17 *id.;* Tr., pp. 392, 396) but also, and much more important, *differences in the service lives actually experienced from those originally estimated.* From time to time the rates are changed as the estimates of service life and salvage are changed. During the period since the acquisition of the property here in question from the American Company, there has been a strong general tendency toward a lengthening of service life and a consequent reduction in depreciation rates (Tr., p. 365; and see footnotes to pp. 48 and 49, *infra*).

Thirdly, it should be noted that, as indicated above (pp. 11-12, *supra*), a telephone company does not make any attempt to set up for each particular unit of property a reserve adequate to provide for the retirement of that unit. On the contrary, as required both by the I. C. C. (Uniform System of Accounts for Telephone Companies, First Issue, Instruction 23) and by the F. C. C. (Uniform System of Accounts for Telephone Companies, Instruction 31.02-80), the appellee employed the "group method" of depreciation accounting. Since the Government's contention in this case hinges upon applying to group depreciation accounting considerations that would be applicable, if at all, only to unit depreciation accounting, it is desirable to explain the fundamental difference between these two methods.

Under the unit method, each unit of property is separately treated in the depreciation accounts. Suppose, for example, that a company acquires 100 units of a particular kind of property which are determined to have an average service life of twenty years and no salvage. Under the unit method, depreciation would be accrued at the rate of 5% per annum against each unit separately. If a particular unit were retired at the end of ten years, the depreciation reserve would be charged only with the amount (50% of the cost of this particular unit) which had been credited to the reserve on account of this unit during these ten years, and the remaining 50% of the cost of the particular unit would be charged at the time of retirement to operating expenses. On the other hand, at the end of the twenty years all depreciation charges would cease for any of the units included in this purchase, no matter how long they continued thereafter to be in service.

On the other hand, under the group method, which has been required in the telephone industry, taking the same illustration, the 100 units would be considered as a group. Annual charges to depreciation would be made at the rate of 5% of the original book cost of all those units which were still in service. If one unit was retired at the end of ten years, the depreciation reserve would be charged with 100% of the book cost of that unit, *although obviously the portion of the depreciation reserve which had been built up by accruals related to that particular unit would amount to only 50% of its book cost.* On the other hand, depreciation charges would continue on as many units as remained in service even after the twenty-year estimated average service life had expired. See *Depreciation Charges of Telephone Companies,* 118 I. C. C. 295, 367 (1926). Under such a method, it would obviously be absurd to say that the company had made insufficient provision for the retirement

of the units which went out of service at the end of ten years, and excessive provision for those which remained in service after twenty years. For the whole basis of the group method of depreciation accounting is that inequalities of this sort are averaged in the rate fixed for the group as a whole.

Finally, it is to be noted that a telephone company has only a single depreciation reserve and not a separate reserve for each class of plant, much less for each unit. The depreciation reserve is "a single composite reserve" to which all depreciation expense charges are credited and against which all retirements are charged.*

With this background, let us now turn to the Government's contention of a deficiency in appellee's depreciation reserve resulting from these purchases.

The issue which this contention raises is an issue, not of correct accounting, but of fact. Yet the Government attempts to resolve it on the basis of pure theory without any inquiry into what the facts actually were. The Government repeatedly *asserts*, in one form or another, that "when the property reached the end of its service life, insufficient amounts had been accumulated in appellee's depreciation reserve to cover the cost of the property as carried in appellee's plant accounts" (Government Brief, p. 22). Yet the record contains no evidence as to what amounts had been accumulated in the depreciation reserve, and efforts on the part of the appellee to show that sufficient amounts had been accumulated were blocked at the hearing.

A contention of inadequate depreciation accruals might conceivably mean any one of three different things. It might mean that appellee's depreciation reserve was insufficient as a whole. A second meaning would be that the portion of the depreciation reserve which had been built up by

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* See Account 102 of I. C. C.'s 1933 System of Accounts and Instructions 31.171 of the F. C. C.'s System, A., pp. 9-10, 13-14.

accruals with respect to those *classes* of property in which the acquisitions from the American Company were included was inadequate to take care of past retirements and leave a reserve sufficient to meet the reserve requirements for these classes. And a third meaning would be that the accruals in respect of the *particular units of plant* acquired from the American Company were insufficient to provide for past retirements of those units and leave a balance sufficient to meet reserve requirements for such of those units as had not yet been retired.

We shall consider each of these possibilities.

(1) The first of these possible meanings, namely, that the depreciation reserve is inadequate as a whole, is not urged by the Government. The Commission itself conceded in its report (R., p. 36):

> "No challenge is here being made to the adequacy of the depreciation reserve as a whole."

Moreover, the appellee offered, and the Commission excluded, an exhibit (Ex. 65 *id.*, Tr., pp. 1322, 1326) showing that appellee's depreciation reserve fully met its reserve requirements.

Actually this concession by the Commission should have ended the entire argument. The only basis on which a company can be required to make a transfer on its balance sheet from surplus to another liability account, in this case depreciation reserve, is that its liabilities (other than surplus) have been understated. Since under the F. C. C.'s own rules (A., p. 14) the depreciation reserve is a "single composite reserve" and since no other liability account is questioned, the Commission's concession of adequacy of the reserve is wholly inconsistent with its order that nearly $4,000,000 be transferred from surplus to it.

(2) An attempt to support the Order on the basis that the portion of appellee's depreciation reserve which had been built up by accruals with respect to the *classes* of property in which the acquisitions from the American Company were included was inadequate to take care of past retirements and leave a reserve sufficient to meet the reserve requirements for these classes of property, must likewise fail. There is no evidence to support such a claim, and if the claim could be supported, it would be irrelevant.

(a) The Commission did not place in the record any studies as to the amount of property included in the various classes into which the property purchased from the American Company fell, the depreciation rates that were used from time to time, the retirements that were charged, the salvage that was realized, the present balances in these accounts, the reserve requirements, or the amount of the "single composite reserve". In fact, the F. C. C. excluded an exhibit offered by the appellee (Ex. 65 *id.*, Tr., pp. 1322, 1326) showing the reserve requirements for each class of property and the adequacy of the "single composite reserve" to meet them. The theoretical argument on which the F. C. C. relies would apply at best to the *initial* depreciation rates, and then only to the particular units of property purchased from the American Company which, in general, comprised a relatively small portion of each class.

Moreover, there was evidence, received or tendered, showing that the effect of the purchase of going or completed plant *was* considered by appellee's management in fixing rates of depreciation for the various classes of its property. The appellee offered in evidence instructions from its chief accounting officer that "a large purchase of going or completed plant might introduce such important changes in

the average service life, book cost and salvage value of the total property as to necessitate a general revision of the depreciation rates, although it does not seem probable that such a situation will arise in the New York Telephone Company", and that "in any revision of depreciation rates the effect of past and prospective purchases of going or completed plant should, of course, be given proper consideration." (Ex. 17 *id.;* Tr. 392, 396). While the Commission refused to admit this evidence, the appellee was fortunate in having the testimony of a witness, actively concerned in these very transactions of many years past, who testified specifically with respect to the toll plant acquired from the American Company (Tr., p. 365) that "we discussed with the engineers the question of the effect of this purchase on the depreciation rates, and whether or not the depreciation rates should be increased to allow for the fact that the property purchased was not new and, therefore, had less than the full life remaining", and that it was determined that such an increase was unnecessary because "there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from this purchase".*

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* The full text of Mr. Trax's testimony, which is reproduced in the Appendix to this brief (A., pp. 15-20), shows that it related specifically to the question whether this *particular* purchase called for changes in depreciation rates. This testimony was in no way affected by the testimony of the two other witnesses, Messrs. Bradshaw and Schaffer, referred to by the Government on pp. 47-48. Mr. Bradshaw's testimony that the rates applied to the toll plant purchased from the American Company were the same rates previously determined, was entirely consistent with Mr. Trax's testimony that these previously determined rates were considered adequate *after* the purchase because "there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from these purchases". Mr. Schaffer's testimony dealt with general questions of accounting theory and had no relationship to any particular depreciation rates.

(b) Not only was there no evidence of a deficiency in depreciation reserve for these particular classes of property, but the record contains specific and uncontradicted expert accounting evidence that even if such a deficiency existed, it would be of no moment if it was offset by an excessive provision for some other class. Mr. M. F. Orton, Director of Research and Valuation for the New York Public Service Commission, testified that a failure to provide sufficient in the reserve for certain classes of property would not justify an order reducing surplus when such a deficiency was counterbalanced by an excess for other classes (A., pp. 25-26). So long as a telephone company has made adequate charges for depreciation against its gross revenues, reducing, to that extent, the amount otherwise available for surplus, the public cannot fairly or lawfully demand that the company reduce surplus a second time simply because it has charged too much for one class of property and too little for another.

(3) The Government's real reliance appears to be on the claim that the amounts accrued in respect of the *particular units* of property purchased from the American Company were not sufficient to take care of past retirements and leave a reserve adequate for the balances remaining on the books. Here again, there are two answers, either of which would be sufficient. There is no evidence to establish the claim, and if the claim were established, it would be irrelevant.

(a) There are no facts to bear out the Government's contention. There is simply nothing in the record as to the portion of appellee's depreciation reserve resulting from accruals made in respect of the property purchased from the American Company, or as to the relationship between accruals, retirements, salvage, present balances and

reserve requirements. The absence of such evidence is, of course, the strongest possible indication that no such claim as that now advanced by the Government was urged before the Commission. The Government's argument is simply an attempt to substitute theory for fact.

Moreover, even as a theoretical argument, and even if it were permissible to look only at the units of property acquired from the American Company (which it is not since telephone companies are not permitted to practice unit depreciation accounting), the Government's argument would be unsound. For it concerns itself solely with the initial depreciation rates and ignores the effect of increased length of service life and related changes in depreciation rates, and of decisions, on this very ground of purchases of going or completed plant, to refrain from making reductions in rates that otherwise would have been made.*

The effect of increased length of service life can be illustrated by the very case put in the footnote to page 44 of the Government's Brief. In this case property having an original cost of $80 and an *estimated* service life of ten years (with no salvage) was acquired for $70 when it was three years old, and the purchasing company applied the same 10% depreciation rate which it applied to property that had been acquired new. The Government says there

* The Government constantly endeavors to center the Court's attention on the depreciation rates initially established, ignoring the effect of the numerous changes made over the years. Thus it states (Government Brief, p. 44) that "The annual depreciation rates which appellee applied thereafter were those which had previously been determined with respect to the property of the class in question * * *". This statement is decidedly misleading unless it is limited to the rates applied *immediately* after the acquisitions. The record made it clear that, both as to the toll plant and as to the instruments, depreciation rates were periodically revised and changed over the entire period up to the effective date of the F. C. C.'s Order (Tr., pp. 365-366, 1016-1017, 1038-1039, 1141, 1313).

would inevitably be a deficit of $21 [*i. e.*, $70—(7 x $7)] in the depreciation reserve. However, if the property *actually* remained in service not for the ten years originally estimated but for thirteen years, and no change was made in depreciation rates, the accruals resulting from application of the 10% rate would be precisely adequate *even in the case of these particular units.* This is enough to show that mere theorizing on this subject, such as that indulged in by the Government, cannot serve as a substitute for the facts. Throughout the period since these acquisitions the tendency was toward precisely this lengthening of service life, the trend of depreciation rates was downward, and even the decreases in depreciation rates which were made by appellee were not deemed sufficient by the New York Public Service Commission (Tr., p. 1141)*.

(b) However, even if there were evidence and not mere theoretical argument that the depreciation accruals in respect of these particular items of property would not be adequate for their retirement, this fact would still be irrelevant. The general point indicated above (pp. 40, 47), namely, that inadequate accruals in respect of one type of property are without significance if they have been counterbalanced by excessive accruals in respect of another type, applies again here. But a further and conclusive reason is that under the group method of depreciation accounting, no *attempt* is made to provide a reserve adequate for the retirement of *any unit* of property, the whole basis of the method being that the amounts accrued will prove inadequate in the case of some units and excessive in the case of others. The depreciation rate for each class is based on the average life of *all the units* in the class. Expectation of shorter than normal lives for particular units is taken into

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* P. U. R. 1930C, 325, 351, and 14 P. U. R. (N. S.) 443, 450-451 (R., pp. 13-14).

account in fixing the average rate applied to all units, not by fixing special rates to be applied to particular units.*

The Government's argument on this entire subject simply begs the question. It claims (Government Brief, p. 49) that appellee's argument is "that the mere fact that it debited its depreciation reserve with more than it had credited thereto is not controlling unless it can be shown that the depreciation reserve as a whole is inadequate," something which it characterizes as a "novel doctrine." The proposition that when an administrative commission seeks to go beyond a reclassification of the accounts with respect to property still on the books and require a further charge to surplus on the basis of asserted inadequacy in the depreciation reserve, it must establish that the reserve is, in fact, inadequate, would not seem such "a novel doctrine" as the Government thinks; but the complete answer is that there is no proof whatever that appellee did "debit its depreciation reserve with more than it had credited thereto". In fact, there is a total absence of evidence as to what either the debits or the credits were, either in detail or even in total.

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* We can perhaps clarify this point with the same hypothetical case given on p. 44 of the Government's Brief. Suppose the American Company acquired \$80 of new property having an estimated life of ten years and no salvage, kept the property for three years and then sold it to appellee for \$70. Suppose that at the same time appellee had \$35 of new property of the same class. Under the system of special depreciation rates on partly used property now advocated by the Government, the company would have to apply to the used property a rate of 14-2/7% so as to retire it in seven years, while it would apply to the property acquired new a rate of 10%, this providing the amount necessary to retire this property at the end of ten years. However, precisely the same depreciation accruals would be provided by applying to *all* of the property a rate of 12.5% under the original estimate of a ten-year life, or by application of the 10% rate if the property had an actual service life of twelve years instead of the ten originally estimated. The application of an average rate to all of the property was the type of depreciation accounting required by the group method prescribed by the I. C. C. and F. C. C. accounting rules and followed by the appellee.

The Government's contention really boils down to a claim that where used property has been acquired, a company's depreciation reserve is *necessarily* inadequate unless special depreciation rates for this particular property have been provided. But neither the I. C. C. nor the F. C. C. System of Accounts requires or even contains any provision for the use of such rates, and the argument completely neglects the effect of changes in service lives and depreciation rates, the group method of depreciation accounting, and the uncontradicted testimony that an inadequate accrual even in respect of an entire class of property would not justify a charge to surplus if this inadequacy was counterbalanced by an excess in respect of some other group.

Our argument here is not, as the Government would have the Court believe (Government Brief, pp. 49-50), that "when the Commission discovers that there is an error in an entry made by a carrier in its depreciation reserve account, the Commission is powerless to require the correction of this error unless it can find that the depreciation reserve as a whole is incorrect." We do not contend that where there is evidence of an "error in an entry made by a carrier in its depreciation reserve account," *e.g.*, a failure to make any charge to depreciation expense for depreciable property or where, as in the case put by the Government (Brief, p. 50), a company has made a completely unauthorized transfer from depreciation reserve to surplus, the Commission may not require that error to be corrected without inquiring whether the depreciation reserve as a whole is adequate. Here, however, there was no evidence of "an error in an entry made by a carrier in its depreciation reserve account." If a company is to be forced to make additions to its depreciation reserve *on the ground that the*

reserve is inadequate, which is something quite different, the Government must prove such inadequacy as a fact. A commission seeking to make a company's depreciation reserve conform to the facts of today cannot lawfully proceed by considering only factors tending to make the reserve inadequate and denying the company the right to show that these have been offset by factors tending to make the reserve excessive. To do so could only result in making the reserve *not* conform to the facts and in forcing the company to misrepresent its financial situation.

The Government can derive no comfort from the provision of Section 220(c) of the Communications Act that "The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry * * *."

The F. C. C.'s order to show cause (R., pp. 47-49) did not call into question any specific entry making a charge to depreciation expense or a debit to the depreciation reserve. It did question the original accounting entries, which have been demonstrated to be correct. No claim was made in the proceedings before the Commission that any order going beyond reclassification of the balances as to the surviving property could be made unless the original accounting was shown to be erroneous.

Appellee's charges to depreciation expense and the credits to depreciation reserve, supposed errors in which are now urged as the basis of the Commission's Order, not only are not mentioned in the order to show cause (R., pp. 47-49) but do not even appear in the record. In the entire course of the proceedings, the Commission raised no question as to any "accounting entry" either to depreciation expense or to depreciation reserve. The only point

with respect to depreciation ever made in the proceedings before the Commission was the contention that appellee should have established special depreciation rates to provide for retiring the particular units of plant acquired by it from the American Company, and that contention has been fully answered (pp. 43-51, *supra*).

The plain facts of the matter are not only that there is no evidence to show an inadequacy in appellee's depreciation accruals, but that to require appellee to charge surplus in order to add $3,879,957.94 to its already adequate depreciation reserve would require appellee to charge its surplus twice. All credits to depreciation reserve, whether in the form of annual charges for depreciation or special transfers from the surplus account, have the effect of making surplus less than it otherwise would be. The Government, in effect, concedes (Government Brief, p. 42) that if the appellee had adopted special depreciation rates designed to provide for the retirement of this particular property at the end of its service life, the F. C. C.'s Order would require a double charge to surplus and would be improper. Yet, as a matter of substance, this is precisely what the present Order does. For the appellee offered to prove the entire adequacy of its depreciation reserve (Ex. 65 *id.;* Tr., pp. 1322, 1326), and adduced specific and uncontradicted testimony that its acquisitions of going or completed plant were taken into consideration in the periodic revisions of depreciation rates (Tr., pp. 365-366).

What the F. C. C. has ordered here would thus not merely place the appellee in the position that it would have been in if its original accounting had conformed with the views of the F. C. C. rather than the requirements of the

I. C. C., but in a very much worse position. The Government's talk of inadequacy in the depreciation reserve is only a form of words designed to conceal that the Commission's real endeavor was completely to revise the initial accounting, ignoring all that has happened in the years between. It is in that sense, and not in the sense of any claim by appellee to a vested right in accounting rules or particular book entries, that this case involves "retroactive accounting" and makes applicable this Court's recent statement, *Claridge Apartments Co.* v. *Commissioner of Internal Revenue*, 323 U. S. 141, 164 (1944), that:

> "Retroactivity, even where permissible, is not favored, except upon the clearest mandate. It is the normal and usual function of legislation to discriminate between closed transactions and future ones or others pending but not completed."

The same salutary principle applies to administrative action. Compare *Morgan* v. *United States*, 304 U. S. 1, 15 (1938).

POINT III.

The Commission's Order constitutes a flagrant violation of the "binding construction" of the Federal Communications Commission's Uniform System of Accounts made in *American Telephone & Telegraph Company* v. *United States*, and the District Court would have been justified in enjoining it upon this ground alone.

We have shown in Points I and II that the injunction granted by the District Court would have been properly issued even if there had been no prior legal proceedings between these parties with respect to the subject-matter

of this litigation. However, that is not the situation here, and the judgment of the District Court should be affirmed on the independent ground that the Order violates the "binding construction" of the F. C. C.'s System of Accounts filed pursuant to this Court's request in the *A. T. & T.* case. As was said in the opinion of the District Court (R., p. 117):

> "The administrative construction referred to, and plainly appearing in the stipulation then filed by the counsel for the Federal Communications Commission, is not present in any of the other cases to which our attention has been called; and this case, for that reason, if for no other, is clearly to be distinguished from those cited. That administrative construction, if none other, it seems to us, precludes the action now taken until (1) there has been a 'fair consideration of all the circumstances,' and (2) unless the difference between the original and present cost is not 'a true increment of value' but is a 'fictitious or paper increment;' and action to obliterate must depend upon 'evidentiary circumstances' later to be developed."

The situation presented by this case is precisely the situation which the "binding construction" required of the F. C. C. in the *A. T. & T.* case was meant to meet. In its opinion in the *A. T. & T.* case, this Court refers (299 U. S. at 240) to the fear on the part of the telephone companies that the Commission, without further consideration, would require the writing off to surplus of all amounts representing the excess of purchase price over the seller's original cost which the Commission was requiring to be recorded in Account 100.4. This Court held (299 U. S. at 240) that if the F. C. C.'s System of Accounts "had the meaning thus imputed to it, there would be

force in the contention that the effect of the order is to distort in an arbitrary fashion the value of the assets." But, the Court said, this is not what the F. C. C.'s System of Accounts means, and the contrary had been made clear by testimony of the Commission's chief accountant and by the argument of Government counsel at the bar. Then follows the statement that "To avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed, we requested the Assistant Attorney-General to reduce his statements in that regard to writing in behalf of the Commission" (299 U. S. at 241).

As a result of this request, there was filed the declaration (R., p. 46) which this Court accepted "as an administrative construction binding upon the Commission in its future dealings with the companies." This declaration stated that amounts included in Account 100:4 representing sums paid by a telephone company for properties acquired from another in excess of the latter's original cost less reserve requirements were not to be written off to surplus if these amounts "are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value," and that when amounts so included "are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, * * *"

In contrast with this fair promise as to the interpretation of its System of Accounts made by the F. C. C. in order to avoid the injunction threatened in the *A. T. & T.* case, that Commission, in the first case in which the application of these features of its System has come in issue,

now proceeds in complete defiance of the "binding construction." It orders the write-off of the entire excess of the purchase price of the property here involved over the American Company's net book cost, although, as found by the District Court, (R., p. 122), it "made no determination with respect to the value of any of the property purchased by the plaintiff from the American Company and counsel for the defendants in this action, upon oral argument, informed the Court that the Commission was not relying on any claim of overvaluation and that for the purposes of this action no such issue existed."

The F. C. C.'s report (R., p. 36) shows that the Commission was not without embarrassment on the score of the "binding construction." It overcame that embarrassment primarily by relying on the theory that the *original entries* were in error. This flanking maneuver permitted the Commission to argue that the only part played by its own Uniform System of Accounts was "to call attention to an impropriety in accounts which should have been corrected even if the new system had not gone into effect" (R., p. 36), and that consequently the "binding construction" of that System did not come into play. Insofar as the Commission's attempted escape from the "binding construction" was founded on this basis, the effort must necessarily fail, for the reasons set forth in Point I of this brief.

The Government, in fact, now makes no attempt to support the departure from the "binding construction" on this basis of error in the original accounting. Its position is rather that where the vendor is an affiliated company, an excess of purchase price over the vendor's net book cost *cannot* represent an investment in an asset of continuing value or be "definitely attributable to depre-

ciable telephone plant", whatever the actual facts may be, and that no further inquiry can or should be made. Judge Swan made the appropriate comment on this argument when he said in the District Court that on any such view the "binding construction" in the *A. T. & T.* case "was a very tricky stipulation," indeed.*

There is not a word either in the "binding construction" in the *A. T. & T.* case or in Mr. Justice Cardozo's opinion which gives any support to the view now urged that consideration of the single fact that assets were purchased from an affiliated company and simultaneous refusal to look at any other facts constitute the "fair consideration of all the circumstances" which the Government promised. Obviously such an "interpretation" of the stipulation is the exact equivalent of saying that whenever property is purchased from an affiliate, the stipulation has no application at all. There is nothing in the language of the stipulation

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* We quote the following from the oral argument in the District Court:

"Judge Swan: And did you make a fair consideration of all the circumstances?

"Mr. Plotkin [Counsel for the F. C. C. and the United States]: Yes. Suppose that these amounts had been put on the books as a result of a straight write-up, the only thing we would look into is not whether at the time of the write-up the property had that value but whether it had been the result of a straight write-up. If that had occurred we would have required that to be eliminated.

"Judge Bright: When that stipulation was made in the A. T. & T. case, you were dealing with dealings between the A. T. & T. and its affiliates, weren't you?

"Mr. Plotkin: There were many such dealings involved.

"Judge Bright: *If that were so, wouldn't the words 'fair consideration of the circumstances' refer to something else than the mere fact of affiliation?*

"Mr. Plotkin: While it is true today that the A. T. & T. controls a substantial part of the telephone business, and while it has been true that it controlled throughout the——

"Judge Swan: *I would say that was a very tricky stipulation.* Perhaps you are right; perhaps we can't hold you to anything else——." (Italics supplied.)

which remotely suggests this, and the record and this Court's opinion in the *A. T. & T.* case make it clear that all parties were fully aware that the bulk of the purchases that would be affected by the "original cost" requirements imposed by the F. C. C.'s System of Accounts were precisely of this type.

The telephone companies understood the "binding construction" in the *A. T. & T.* case to mean that the F. C. C. would look into all the facts and circumstances and not merely at one of them. They recognized, of course, that if in any case asset accounts contained entries where no property had, in fact, been received, as in *Northwestern Electric Co.* v. *Federal Power Comm.*, 321 U. S. 119 (1944), amounts represented by such entries would not be permitted to remain. They realized also that if amounts paid for physical plant exceeded the fair value of the plant so acquired, these amounts likewise would be required to be written off. But both the language of the stipulation and the circumstances which led to its being made gave them the fullest assurance that where, as here, physical property had been acquired at a price believed by the parties to represent its fair market value at the time, the accounting company would be given an opportunity to substantiate that fact and would not be met by the argument that *under no circumstances* can a payment to an affiliated company in excess of the latter's net book cost be deemed to constitute an investment "in assets of continuing value" or to be "definitely attributable to depreciable telephone plant."

The Government talks (p. 29) of the possibility of property being transferred from one corporation to another for the purpose of swelling surplus. Where this is shown, a commission might well be justified in refusing to go farther into the facts. But what application does all this have to transactions such as these, concededly entered into for

a proper business purpose and handled on the very basis prescribed by the Federal administrative agency then in control?

If this Court had exacted from a private litigant any such stipulation as that made by the Government in the *A. T. & T.* case, it is unthinkable that it would permit the stipulation to be evaded on any such flimsy pretext as that which the Government has advanced here. Surely, the Court will not require a lesser standard of conduct from agencies of Government which must accredit themselves "by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play." *Morgan v. United States, supra,* at p. 22.

Conclusion.

The District Court was right in sending this Order back to the F. C. C. for further consideration.

The Order cannot be sustained as one reclassifying the balances in appellee's property accounts to conform to the Commission's System of "original cost" accounting, since nearly three-fourths of this property has already been written off the books and since the Order does not even purport to follow the new System of Accounts. The F. C. C. sought to sustain its action by the theory, which is shot through its report, that the appellee was guilty of an error in the original accounting which the F. C. C. might now correct. That theory being demolished, the Order necessarily falls with it. It is not for the courts to attempt to patch up the Order on the basis of a merely theoretical argument as to inadequacy of depreciation reserve, and a wholly unsound one at that, when no such issue was raised by the F. C. C.'s order initiating this proceeding and the record is devoid of any factual evidence to support the

claim. Beyond this, the Court should not permit the stipulation which it exacted in the *A. T. & T.* case to be flouted as the F. C. C. has done here.

Whatever order the F. C. C. may be in a position to make, it far exceeded its powers when it made the Order here under review.

The judgment of the court below should be affirmed.

Respectfully submitted,

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Supreme Court of the United States

October Term, 1945—No. 55.

UNITED STATES OF AMERICA and
FEDERAL COMMUNICATIONS COMMISSION,
Appellants,

v.

NEW YORK TELEPHONE COMPANY,
Appellee.

APPENDIX TO BRIEF FOR NEW YORK TELEPHONE COMPANY, APPELLEE.

Appendix I—Statutes and Administrative Regulations

Appendix II—Excerpts from Administrative Record

INDEX.

Appendix I.

Statutes and Administrative Regulations.

The pertinent provisions of the Interstate Commerce Act (24 Stat. 379, 386, as amended by the Acts of June 29, 1906, 34 Stat. 584, 593, 594, and of June 18, 1910, 36 Stat. 539, 555) are as follows:

> "Sec. 20. (5) The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to the provisions of this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys. * * * The Commission shall at all times have access to all accounts, records, and memoranda, including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by carriers subject to this Act, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto, and it shall be unlawful for such carriers to keep any other accounts, records, or memoranda than those prescribed or approved by the Commission, and it may employ special agents or examiners, who shall have authority under the order of the Commission to inspect and examine any and all accounts, records, and memoranda, including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by such carriers. * * *"

The pertinent provisions of the Communications Act of 1934 (48 Stat. 1064, Chapter 652, as amended, 50 Stat. 189, Chapter 229) are as follows:

"SEC. 220 (a) The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys."

"SEC. 220 (c) The Commission shall at all times have access to and the right of inspection and examination of all accounts, records, and memoranda, including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by such carriers, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by such person. Any provision of law prohibiting the disclosure of the contents of messages or communications shall not be deemed to prohibit the disclosure of any matter in accordance with the provisions of this section."

"SEC. 220 (g) After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to

such persons by the Commission at least six months before the same are to take effect."

"SEC. 402 (a) The provisions of the Act of October 22, 1913 (38 Stat. 219), relating to the enforcing or setting aside of the orders of the Interstate Commerce Commission, are hereby made applicable to suits to enforce, enjoin, set aside, annul, or suspend any order of the Commission under this Act (except any order of the Commission granting or refusing an application for a construction permit for a radio station, or for a radio station license, or for renewal of an existing radio station license, or for modification of an existing radio station license, or suspending a radio operator's license), and such suits are hereby authorized to be brought as provided in that Act."

"SEC. 604 (a) All orders, determinations, rules, regulations, permits, contracts, licenses, and privileges which have been issued, made, or granted by the Interstate Commerce Commission, the Federal Radio Commission, or the Postmaster General, under any provision of law repealed or amended by this Act or in the exercise of duties, powers, or functions transferred to the Commission by this Act, and which are in effect at the time this section takes effect, shall continue in effect until modified, terminated, superseded, or repealed by the Commission or by operation of law."

The pertinent provisions of the Interstate Commerce Commission's Uniform System of Accounts for Telephone Companies, Class A and Class B, effective January 1, 1913, are as follows:

"10. Costs to be actual money costs.—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. When the consideration actually given for anything with respect to which a charge is made to any fixed capital or other property account is anything other than money, the actual consideration should be described in the entry with sufficient fullness and particularity to identify it, and the amount charged should be the actual money value of such consideration at the time of the transaction."

"13. Plant and equipment and other property purchased.—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, 'Other Intangible Capital,' and the appraised values of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value should be distributed through the said accounts in proportion to the said appraised value of the

constituent elements appropriate to the respective accounts.

"Companies should be prepared to furnish the Commission, upon demand, a full report of the contract of acquisition, the consideration given therefor, the determination of the actual money value of such consideration if other than money, the appraisal, and the amounts charged to the respective accounts for each plant or other such fixed capital purchased. The purchaser is required to procure in connection with the acquisition of any such plant or other fixed capital all existing records, memoranda, and accounts in the possession or control of the grantor relating to the construction and improvement of such plant, and to preserve such records, memoranda, and accounts until authorized by law to destroy or otherwise dispose of them."

"23. Depreciation of plant and equipment.—Telephone companies should include in operating expenses depreciation charges for the purpose of creating proper and adequate reserves to cover the expenses of depreciation currently accruing in the tangible fixed capital. By *expense of depreciation* is meant——

"(a) The losses suffered through the current lessening in value of tangible property from wear and tear (not covered by current repairs).

"(b) Obsolescence or inadequacy resulting from age, physical change, or supersession by reason of new inventions and discoveries, changes in popular demand, or public requirements, and

"(c) Losses suffered through destruction of property by extraordinary casualties.

"The amount charged as expense of depreciation should be based upon rules determined by the accounting company. Such rules may be derived from a consideration of the company's history and experience. * * *

"The rate of depreciation should be fixed so as to distribute, as nearly as may be, evenly throughout the life of the depreciating property the burden of repairs and the cost of capital consumed in operations during a given month or year, and should be based upon the average life of the units comprised in the respective classes of property."

"102. Reserve for Accrued Depreciation—Cr.[1]

"Credit to this account such amounts as are concurrently charged to account No. 608, 'Depreciation of Plant and Equipment,' No. 701, 'Shop Expense,' No. 702, 'Stable and Garage Expense,' and No. 703, 'Tool Expense,' to cover the expense of depreciation of plant, equipment, furniture, tools and implements, as specified in the text of these accounts. This account should also be credited with any amount carried in reserve on January 1, 1913, to cover the expense of depreciation on plant, equipment, furniture, tools and implements installed prior to that date.

"Charge to this account the realized depreciation of tangible fixed capital installed since December 31, 1912, when such capital is relinquished, retired, or destroyed, also the amount of depreciation carried herein in respect to tangible fixed capital installed prior to January 1, 1913, when relinquished, retired, or destroyed. (See secs. 14, p. 34 and 23, p. 67.)

"Charge also to this account such part of the expenditures for extraordinary repairs as is concurrently credited to account No. 611, 'Repairs Charged to Reserves—Cr.' "

"[1] The total of accounts Nos. 100 and 101 should be drawn down on the balance-sheet statement, and the total of accounts Nos. 102 and 103 deducted therefrom, the difference being shown as the net total."

The pertinent provisions of the Interstate Commerce Commission's Uniform System of Accounts for Telephone Companies, First Revised Issue, effective as to Class A Companies January 1, 1933, are as follows:

"21. Telephone plant purchased.—(A) When property in use in telephone service (note instruction 3-AA) is purchased, the accounting therefor shall be as follows:

"(B) There shall be charged as of the date of purchase:

"(1) To account 211, 'Land,' the estimated current value of the land.

"(2) To the depreciable plant accounts the current cost new (estimated if not known), of the property classable therein.

"(3) To account 202, 'Franchises,' the original cost of all governmental franchises and similar rights acquired.

"(4) To accounts 232, 'Station installations,' and 233, 'Drop and block wires,' such proportion of the estimated current cost new, of the plant includable in each of these accounts as the estimated remaining service life of the respective classes of plant includable therein bears to the average over-all service life of the same class of plant installed by the accounting company.

"(5) To account 280, 'Construction work in progress,' the cost of any uncompleted projects acquired.

"(C) The estimated amount of the reserve requirements applicable to the plant shall be credited to accounts 171, 'Depreciation reserve,' and 172, 'Amortization reserve.'

"(D) The difference between the net of the amounts includable in these accounts as provided in the foregoing paragraphs B and C and the cost to the accounting company of the plant purchased shall be debited or credited as appropriate to account 278, "Undistributed cost of property,' except that when any difference thus chargeable to account 278 applies to duplicate or other telephone plant which will be retired by the purchaser in the reconstruction of the purchased property and its consolidation with previously owned property, the accounting for the amount applicable to such plant shall be presented to this Commission for consideration and approval.

"(E) Upon application by the company, in each instance, to this Commission and subject to its approval, the company may charge to its telephone plant accounts and may also credit to its depreciation and amortization reserve accounts the amounts carried in those accounts by the vendor company with respect to the property purchased."

"80. Computation and filing of depreciation rates.—(A) The company shall file with the State commission or commissions having jurisdiction, for review and recommendations to this Commission, estimates of the composite annual percentage rates considered applicable to the book cost of each class of depreciable telephone plant owned or used by the company. These percentage rates shall be based upon the estimated service values and service lives developed by a study of the company's history and experience and such engineering and other information as may be available with respect to prospective future conditions. These percentage rates shall be computed in conformity with the group plan of accounting for depreciation and shall be such that the loss in service value of the property, except for losses excluded under the definition of depreciation (note instruction 3-J), may be distributed

under the straight-line method (note instruction 3-Z) during the service life of the property. Such percentage rates shall for each primary account comprised of more than one class of property produce a charge to operating expenses for that account equal to the sum of the amounts that would otherwise be chargeable for each of the various classes of property included in the account. * * *"

"3. Definitions.—When used in this system of accounts:

*   *   *   *   *   *

"(L) 'Group plan,' as applied to depreciation accounting, means the plan under which depreciation charges are accrued upon the basis of the book cost of all property included in each depreciable account, using the average service life thereof properly weighted, and upon the retirement of any depreciable property its full service value is charged to the depreciation reserve whether or not the particular item has attained the average service life."

"171. Depreciation reserve. — (A) This account shall be credited with amounts concurrently charged to account 608, 'Depreciation,' and account 702, 'Vehicle and other work equipment expense,' for currently accruing depreciation (note instruction 3-J) of telephone plant (see also instructions 80, 81, and 82). It shall also be credited with any amounts which the company may elect to charge to account 413, 'Miscellaneous debits to surplus,' and transfer to this account in respect of past accrued depreciation not provided for. (See also instructions 20-C and 21.)

"(B) at the time of retirement of depreciable telephone plant, this account shall be charged with the book cost of the property retired plus the cost of removal (except the cost of removal of station apparatus) and shall be credited with the salvage value and insur-

ance recovered, if any. It shall be credited with amounts chargeable to account 138, 'Extraordinary maintenance suspense,' as provided in instruction 83. (See also instruction 25.)

"(C) For corporate ledger and balance sheet purposes this account shall be regarded and treated as a single composite reserve. However, for purposes of analysis, each company shall maintain subsidiary records in which the depreciation reserve is broken down into component parts corresponding to the primary telephone plant accounts which include depreciable telephone plant (see also instruction 82); these subsidiary records shall show the current credits and debits to the reserve in complete detail by such primary plant accounts."

The pertinent provisions of the Federal Communications Commission's Rules and Regulations (47 Code Federal Register 31.01-1 *et seq.*) are as follows:

"31.02-80 Computation of depreciation rates. (a) Depreciation charges shall be computed by applying the composite annual percentage rates considered applicable to the original cost (note Sec. 31.01-3 (x)) of each class of depreciable telephone plant owned or used by the company. (Note also Sec. 31.02-81 (b).) These percentage rates shall be based upon the estimated service values and service lives (note Sec. 31.01-3 (dd), (cc)) developed by a study of the company's history and experience and such engineering and other information as may be available with respect to prospective future conditions. These percentage rates shall be computed in conformity with the group plan (note Sec. 31.01-3 (p)) of accounting for depreciation and shall be such that the loss in service value of the property, except for losses excluded under the definition (note Sec. 31.01 (m)), may be distributed under the straight-line method (note Sec. 31.01-3 (ff)) during the service life of the property. Such percentage rates shall not include any allowance for loss in service value of property expected to be installed in the future. The percentage rates shall, for each primary account comprised of more than one class of property, produce a charge to operating expenses for that account equal to the sum of the amounts that would otherwise be chargeable for each of the various classes of property included in the account."

"31.01-3 Definitions. When used in this system of accounts:

• • • • • •

"(p) 'Group plan,' as applied to depreciation accounting, means the plan under which depreciation charges are accrued upon the basis of the original cost (note paragraph (x) of this section) of all property in-

cluded in each depreciable plant account, using the average service life thereof properly weighted, and upon the retirement of any depreciable property its full service value is charged to the depreciation reserve whether or not the particular item has attained the average service life.''

''31.100:4 Telephone plant acquisition adjustment. (a) This account shall include amounts determined in accordance with Sec. 31.2-21 representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost (note Sec. 31.01-3 (x)) of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired. If the actual original cost is not known, the entries in this account shall be based upon an estimate of such cost.

* * * * * *

''(c) The amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct.''

''31.2-21 Telephone plant acquired. (a) When property comprising a substantially complete telephone system, exchange, or toll line is acquired from predecessors, the amount of money actually paid (or the current money value of any consideration other than money exchanged) for the property (together with preliminary expenses incurred in connection with the acquisition) shall be charged to Account 276, 'Telephone plant acquired.' (Note also Account 139.)

''(b) The accounting for the acquisition of the plant shall then be completed as follows:

"(1) The original cost, estimated if not known (note Sec. 31.01-3 (x)), of telephone plant, governmental franchises and other similar rights acquired shall be charged to the telephone plant accounts, Account 100:2, 'Telephone plant under construction,' and Account 100:3, 'Property held for future telephone use,' as appropriate, and credited to Account 276. When the actual original cost cannot be determined and estimates are used, the company shall be prepared to furnish this Commission with the particulars of such estimates.

"(2) The amounts of the reserve requirements for depreciation and amortization of the plant acquired shall be credited to Account 171, 'Depreciation reserve,' and Account 172, 'Amortization reserve,' and debited to Account 276.

"(3) The amount remaining in Account 276, 'Telephone plant acquired,' applicable to the plant acquired, shall, upon completion of the entries provided in the foregoing subparagraphs (1) and (2), be debited or credited, as appropriate, to Account 100:4, 'Telephone plant acquisition adjustment,' except that when any amount thus chargeable to Account 100:4 applies to duplicate or other telephone plant which will be retired by the vendee in the reconstruction of the acquired property and its consolidation with previously owned property, the accounting for the amount applicable to such plant shall be submitted to this Commission for consideration and approval.

"(c) The accounting for property acquired from predecessors, not provided for in paragraphs (a) and (b), shall be on basis of the amount of money actually paid (or the current money value of any consideration other than money exchanged) for such property."

"31.171 Depreciation reserve. (a) This account shall be credited with amounts concurrently charged

to Account 608, 'Depreciation,' and to clearing accounts for currently accruing depreciation (note §31.01-3(m)) of telephone plant. (Note also §§31.02-80 to 31.02-82.) It shall also be credited with any amounts which the company may elect to charge to Account 413, 'Miscellaneous debits to surplus,' and transfer to this account with respect to past accrued depreciation not provided for. (Note also §§31.2-20(b), 31.2-21.)

"(b). At the time of retirement of depreciable telephone plant, this account shall be charged with the original cost (note §31.01-3(x)) of the property retired plus the cost of removal (except the cost of removal of station apparatus) and shall be credited with the salvage value and insurance recovered, if any. It shall be credited with amounts chargeable to Account 138, 'Extraordinary maintenance and retirements,' as provided in §31.02-83. (Note also §31.2-25.)

"(c) For corporate ledger and balance-sheet purposes this account shall be regarded and treated as a single composite reserve. However, for purposes of analysis, the company shall maintain subsidiary records in which the depreciation reserve is broken down into component parts corresponding to the primary telephone plant accounts which include depreciable telephone plant (note also §31.02-82); these subsidiary records shall show the current credits and debits to the reserve in complete detail by such primary plant accounts."

Appendix II.

Excerpts from Administrative Record.

Certain portions of the administrative record which has been transmitted to this Court as an original document are printed herein for the convenience of the Court (R., p. 136).

Testimony of Mr. H. A. Trax:

"Q. (by Mr. Blackman.) You were Chief Accountant for the New York Company for about twelve to thirteen years?

"A. Yes.

"Q. And your connection with the New York Company ceased when you went to the New Jersey Company, is that right?

"A. That is right.

"Q. Please state what positions you held with the New York Company from the time you first went there until you left?

"A. My title was that of Chief Accountant during the whole period.

"Q. What were your duties?

"A. I was in charge of staff work, reporting to the Vice-President and General Auditor, and it was my duty to handle problems relating to the classification of accounts and the accounting procedure to be followed by the line organization of the accounting department, development of methods, and I was also engaged in rate case work over a good part of that time.

"Q. And while you were Chief Accountant was it necessary for you to become, and did you become, familiar with the uniform system of accounts for telephone companies prescribed by the Interstate Commerce Commission?

"A. Yes, sir, I did.

* * * * * *

"Q. I understood you to say it was part of your duties to see that the rules of the Interstate Commerce Commission were complied with by the company so far as accounting was concerned?

"A. That is right.

"Q. And in that connection was it a part of your duties to prepare instructions covering the application of these rules?

"A. Yes, sir.

"Q. Do you remember a transaction that took place in 1925 and another in 1926 with respect to the purchase of certain toll lines by the New York Telephone Company from the American Company?

"A. I do, yes, sir.

"Q. What, if anything, did you have to do with those transactions?

"A. Well, I was responsible for supervising the entries to be made on the books of the New York Telephone Company reflecting the transaction as it occurred.

"Q. Do you remember just how that was treated on the books?

"A. Yes, the properties purchased were charged on the books to the various fixed capital accounts at the price paid for the property by the New York Telephone Company.

"Q. Do you know Mr. Bradshaw who testified here today?

"A. Yes, I do.

"Q. Was he connected with your department of the Telephone Company in 1925 and 1926?

"A. Yes.

"Q. In what capacity?

"A. He was an accountant and his particular responsibility at that time had to do with the classification of plant accounts as I recall it, and maintenance accounts too I believe.

"Q. Was he directly connected with you and reporting to you?

"A. Indirectly, yes, sir.

"Q. He was a part of your organization?

"A. He was.

"Q. And he reported directly to whom?

"A. Mr. Young.

"Q. What is his name, please?

"A. Mr. B. F. Young, who was Assistant Chief Accountant at that time.

"Q. And what was his relationship to you?

"A. He was assistant, had the title of Assistant Chief Accountant.

"Q. He reported to you?

"A. He did.

"Q. So Mr. Bradshaw reported to Mr. Young, and Mr. Young reported to you?

"A. That is right.

"Q. After the purchase of this property was set up on your books how was the matter of depreciation dealt with?

"A. The depreciation rates that were in effect at the time were applied to the increased amounts in the fixed capital account, which resulted from the purchase of the property, to determine the amount of depreciation expense charged to Account 608, and credited to depreciation reserve.

"Q. There was no so-called acceleration because of the fact that this property was not new?

"A. No, the depreciation rates themselves were not increased at that time on account of the purchase.

"Q. But the same rates that were applied to similar property which you had built and which had been in effect from the beginning were applied to this property?

"A. That is right.

"Q. Now why was that practice followed?

"A. At the time the transaction occurred consideration was given to the effect of the taking of this used property into the company's accounts, and it was

decided that the total depreciation accrual at the rates then in effect would be ample without any increase in the specific rates effected by these purchases, and therefore that no change should be made in those rates.

"Q. While you were with the Company, Mr. Trax, was there ever any allocation made of the general reserve for depreciation against separate accounts?

"A. No, the balance in the depreciation reserve was shown only in total for all classes of property, and likewise the charge to depreciation expense and credits to the reserve for each period were shown only in total on the books.

"Q. How was the amount of the annual expense of depreciation built up and dealt with during the time that you were Chief Accountant?

"A. The amount to be charged to expense was computed by applying to each of the fixed capital accounts the depreciation rate that had been determined for that account, and the total amount to be accrued for all of the accounts was then added together, and that sum total was charged to depreciation expense, and credited to the reserve as one lump sum.

"Q. Do you remember what was the number of the depreciation expense account?

"A. The expense account was Account 608 as I recall it.

"Q. And the only figures that were entered in that account were these totals that you speak of?

"A. That is right.

"Q. But they were developed in the manner you have just stated?

"A. Yes, they were supported by the detailed computation of course, which was made by applying each specific rate to the individual accounts.

"Q. Mr. Trax, it appears from the records that you represented the Accounting Department on the Committee that dealt with the purchase of these poles. Do

you remember what your activities were in that connection?

"A. Well, it was my responsibility there to advise the committee on any matters involving accounting problems. As I recall it, I did not sit in on all of the meetings of the committee because very frequently the work of the committee did not deal with accounting matters at all. It had to do more with the operation and management problems and with those relating to the inventory and appraisal.

"Q. Do you have definite recollection at the present time of the particular matters that were discussed by you?

"A. In the committee?

"Q. Yes.

"A. I don't remember. I would not be able to recall now any specific question that came up in the committee. I know that we discussed with the engineers the question of the effect of this purchase on the depreciation rates, and whether or not the depreciation rates should be increased to allow for the fact that the property purchased was not new and, therefore, had less than the full life remaining.

"Q. It was the result of all that discussion that it was determined it was not appropriate or reasonable to increase the rates?

"A. Yes. Of course we looked at the problem from the standpoint of the overall effect of any changes that would be made. The ruling consideration always was whether the total depreciation accrual for any given period was ample, and it was decided definitely that without any increase in the rates the rates that were already in effect would be ample to provide for retirement of the property purchased. The reason for that was that there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from this purchase. That lengthening tendency in the life of the plant was,

of course, reflected in revisions of depreciation schedule from time to time which were I believe in practically every case a downward revision, at least in the total they were downward revisions from time to time." [Tr. pp. 358-366.]

Testimony of Mr. F. J. Kurriss

"Q. (Mr. Blackman.) Mr. Kurriss, what is your business?

"A. I am appraisal engineer of the building and equipment of the New York Telephone Company. In that capacity I am responsible for valuations of buildings and equipment including station apparatus and sundry equipment and also responsible for the development of proper rates of depreciation expense and associated reserve requirements for those classes of plant.

"Q. Does that station apparatus include the property that is known as the instrument?

"A. Yes, it does.

"Q. How long have you been associated with the New York Telephone Company?

"A. For almost twenty years.

"Q. What in—in what capacities?

"A. In various engineering and staff capacities. [Tr. pp. 1005-1006.]

* * * * * *

"Commissioner Maltbie: Did you make any study since 1927 as to what happened after 1927?

"The Witness: Oh yes, we are doing that.

"Commission Maltbie: As to these instruments?

"The Witness: As to these particular instruments.

"Commissioner Maltbie: As to this sort of thing you are talking about?

"The Witness: Not as an individual study. They are included as part of our depreciation study.

"Commissioner Maltbie: This type of instrument that was transferred to the New York Telephone Company, did you make any studies of that since 1927?

"Mr. Blackman: Do you mean, Mr. Chairman,—

"Commissioner Maltbie: Let the witness answer this question, if he wants to.

"The Witness: I assume you are referring to the desk stand instrument?

"Commissioner Maltbie: I am referring to the receivers, transmitters and induction coils that were transferred to the New York Telephone Company.

"The Witness: Yes, our latest depreciation study —

"Commissioner Maltbie: The answer is yes?

"The Witness: Yes.

"Commissioner Maltbie: What date was that study made?

"The Witness: In connection with the—

"Commissioner Maltbie: I would like to see a witness once that will answer a question directly. Mr. Blackman was on the stand once in our case and he answered the questions directly. I would like to see some of his witnesses do that.

"The Witness: My recollection is that that study was made early in 1938.

"Commissioner Maltbie: As of 1938?

"The Witness: The depreciation study was as of January 1, 1938.

"Commissioner Maltbie: And limited to the instruments that were transferred in 1927?

"The Witness: The study covered the entire station apparatus account. But the purchased instruments are shown as part of the study.

"Commissioner Maltbie: What did the results of that study show?

"The Witness: What did they show with respect to the life of the instruments?

"Commissioner Maltbie: Yes.

"The Witness: In that study we had assumed that the instrument would have a life similar to the station apparatus, that is, the stands with which they are associated.

"Commissioner Maltbie: You make that assumption. You did not trace through the receivers, transmitters, and induction coils that were transferred?

"The Witness: There is no practicable way that could be done.

"Commissioner Maltbie: No, no, no. Answer the question.

"The Witness: No.

"Commissioner Maltbie: That is right. Answer yes or no if you can but don't go off and discourse about some other subject. So you don't know what the actual experience of the company was after 1927 as to this property that was transferred so far as receivers, transmitters and induction coils were concerned; is that right?

"The Witness: Not of the purchased instruments by themselves. [Tr. pp. 1016-1018]

* * * * * *

"Q. (Mr. Blackman) Mr. Kurriss, will you please to describe just how you developed this Exhibit No. 50.

"A. During 1927 studies had just been completed by the New York Company of a new schedule of depreciation rates. These rates were based on average location or service life as determined from turnover cycles. These rates were seven per cent for New York City, which was based on an estimated average salvage of 65 per cent, and an average location life of five years. And for the plant outside of New York City the rate was 4.6 per cent and was based on an average salvage of 70 per cent and an average location life of six and a half years. These rates were actually placed in effect on January 1, 1929.

"Mr. McVeigh: They were rates for what?

"The Witness: Station apparatus.

"Commissioner Maltbie: For all accounts, not for receivers, transmitters and induction coils which were purchased from the A. T. & T.?

"The Witness: No, but they were included in that account.

"Commissioner Maltbie: Oh yes, but there were a lot of other things.

"The Witness: Yes sir.

"Mr. McVeigh: You say those receivers, transmitters and induction coils were included in this study?

"The Witness: What I intended to say was that these rates which were placed in effect were applicable to the entire station apparatus account which included the transmitters, receivers and induction coils.

"This study was actually based on data through the year 1925.

"Mr. McVeigh: Before the New York Telephone Company purchased the receivers, transmitters and induction coils from the A. T. & T.?

"The Witness: That is correct.

* * * * * *

"Mr. Myse: Before we go further on these exhibits, these rates set forth were changed ultimately by the company, were they not?

"The Witness: They have been changed several times since then." [Tr. pp. 1036-1039.]

Testimony of Mr. H. C. Carpenter

"Q. (by Mr. Blackman). Mr. Carpenter, what is your business?

"A. I am the Vice-President in charge of the operating staff of the New York Telephone Company.

"Q. How long have you been connected with the New York Telephone Company?

"A. Since November 1, 1899.

"Q. Will you state briefly the positions which you have held in that company from the beginning until 1930?

"A. I started in the Engineering Department, and I spent a few years doing drafting and blueprinting and testing of various kinds. Then I was Plant Ex-

tension Engineer—I guess it was Plant Extension and Transmission Engineer. Then I was Engineer in charge of the department for a few years. Then I was Chief Engineer for a few years. Then I was General Manager of the downstate area, and then I was made Vice-President in charge of the staff, the position I now have.

"Q. In 1927?

"A. I think it was, I am not sure of the date.

"Q. Or thereabouts?

"A. It was 1926 or 1927, I think it was 1926. [Tr. pp. 513-514.]

* * * * * *

"Commissioner Maltbie: Don't you know that reductions were made in your annual rates because of what was said to be an excessive accumulation in your reserve in the last—well, 10 years?

"The Witness: Will you repeat that?

"Commissioner Maltbie: The New York Telephone Company now, I am talking about.

"Mr. Blackman: Within the last ten years.

"Commissioner Maltbie: Yes.

"The Witness: Will you read the question?

"(Whereupon the question was repeated by the reporter).

"Commissioner Maltbie: That is, the reductions were made in the last 10 years.

"The Witness: The reductions were made in the last 10 years, but I never knew it was for that reason.

"Commissioner Maltbie: You never knew that?

"The Witness: No.

"Commissioner Maltbie: Are you familiar with the discussion and correspondence between the Commission and the New York Telephone Company?

"The Witness: I am.

"Commissioner Maltbie: As to the change in rates?

"The Witness: I am.

"Commissioner Maltbie: And you want to say that you don't know that the amounts in the reserves had any effect upon the changes in the rates thereafter?

"The Witness: I don't know what was in the minds of the Commission, but my distinct understanding was that the question was, that the point raised was that the annual charges that we were then making were too high, and in my discussions about the matter nothing was ever raised about relating the reduction in the annual rate to the alleged excessive depreciation reserve." [Tr. pp. 1141-1142.]

Testimony of Mr. M. F. Orton:

"Q. (by Mr. McVeigh) What is your present position, Mr. Orton?

"A. I am employed by the Public Service Commission of the State of New York as director of research and valuation.

"Q. Will you state your duties in connection with that office?

"A. I have been so employed from July, 1930, to date. My duties include the supervision of the valuation work conducted by the Public Service Commission, in connection with electric, gas and steam utilities, and to some extent in connection with other utilities; the handling of rate matters involving electric, gas and steam utilities, and also to some extent in connection with other types of utilities, and the conduct of any type of research which may arise to be assigned for study by the Commission.

"Q. What other duties do you have, Mr. Orton?

"A. Well, the valuation work includes, and in fact consists largely of engineering and accounting examinations for the purpose of determining the original cost of the existing property, of the utilities, of the classes mentioned, within the state.

"In addition I have had the chief responsibility for the revision of the uniform system of accounts, pre-

scribed by the New York Commission for electric, gas, water, telephone, omnibus and motor carrier companies. [Tr. pp. 1716-1717.]

* * * * * *

"Q. (by Mr. Blackman) Well, then, do you say that if this company had bought this property from the American company, and then set up on its books no more than the net cost to the American company, but had used depreciation rates, the same depreciation rates that it actually did use, that there would be an inflation?

"A. Well, I think that there would have been some deficiency in the reserve.

"Q. Please, Mr. Orton, would you say that in that case there was a deficiency—I mean an inflation?

"A. I would not characterize it as such unless there was a deficiency over the depreciation accruals as a whole. I was going to add, I believe there is a deficiency in the accruals on the instruments, but I can't say it is not offset by excesses on the other types of plant; on the whole, I would not say that that adjustment in depreciation practices, that there would have been any deficiency in the depreciation accruals.

"Q. Then it is your opinion, is it, as I understand it, that if the company has provided on the whole enough or more than enough in its reserve for depreciation for all 22 classes of plant, considered as a whole, it is a matter of no consequence that it has failed to provide quite enough for two or three classes.

"A. That is correct.

"Q. And the reason why it has failed to do that is also a matter of no consequence.

"A. Well, I don't know to what extent that consideration might be taken, but I certainly would not require an adjustment to increase the reserves to surplus on account of that situation, the way you state it." [Tr. pp. 1983-1984.]

Supreme Court of the United States

October Term, 1945—No. 55.

UNITED STATES OF AMERICA and FEDERAL COMMUNICATIONS COMMISSION,

Appellants,

v.

NEW YORK TELEPHONE COMPANY,

Appellee.

BRIEF FOR THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *AMICUS CURIAE.*

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Dated: November 12, 1945.

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Preliminary Statement.

This brief is filed on behalf of the Public Service Commission of the State of New York, pursuant to subdivision 9 of Rule 27 of the Rules of this Court.

Apart from the interest which the New York Public Service Commission has in common with the commissions of other states and with various federal commissions in the questions of law involved herein, the New York Public Service Commission has a direct interest in this case, since it held hearings jointly with the Federal Communications Commission in this case and issued an order substantially identical with that of the Federal Communications Commission.

A proceeding for the review of the order of the New York Commission has been brought in the Appellate Division of the Supreme Court of the State of New York but the argument thereof has been deferred, pending the decision by this Court in the present case.

The opinion of the New York Commission was made a part of the moving papers upon the motion for summary judgment and is part of the transcript filed in this Court. For the convenience of the Court, ten additional copies of the opinion of the New York Commission have been filed with the Clerk of the Court.

The New York Public Service Commission maintains that its order has independent validity, as an order made in the exercise of its jurisdiction over the accounts of the appellee, a New York corporation engaged principally in intrastate business, under the provisions of Article 5 (§§90 to 103) of the Public Service Law of the State of New York. The transfer of the property by the American Telephone and Telegraph Company* to the appellee at a sum in excess of the A. T. & T.'s net book cost violated an explicit rule promulgated by the New York Public Service Commission, in force at the time of the transaction. It also violated the system of accounts for telephone companies then in force in New York State. However, the validity of the New York order under the specific administrative rules prevailing in New York State will not be elaborated herein. This brief will deal only with the validity of the federal order.

* Hereafter referred to as A. T. & T.

The Decision of the Court Below.

The court below held in substance that, upon a transfer of telephone property by a parent telephone corporation to a wholly owned subsidiary, it is proper for the subsidiary corporation to set up the property on its books of account at a net book cost in excess of the actual net cost to the parent corporation.

This holding presents the fundamental question of law in which the Public Service Commission of New York State and the commissions of many other states are vitally interested. The holding of the court below places telephone companies in a position different from that of all other public utility companies and exempts them from the rule forbidding intercompany profits between affiliates which this Court has uniformly applied in gas and electric company cases (*Colorado Interstate Gas Company* v. *Federal Power Commission*, 324 U. S. 581; *Pennsylvania Power & Light Co.* v. *Federal Power Commission*, 139 Fed. 2nd 445, cert. denied 321 U. S. 798).

We submit that the decision of the court below is wholly incompatible with the opinion of this Court in the *Colorado* case and that, upon the authority of that case, the judgment appealed from must be reversed.

The facts are fully stated in the Government's brief and will not be repeated here.

SUMMARY OF ARGUMENT.

I.

The order of the Commission directing that the intercompany profit be excluded from the net book cost of the property on the appellee's books was proper.

II.

The inflation of the net book cost of the property on the books of the appellee was not eliminated by the subsequent retirement of part of the property.

ARGUMENT.

POINT I.

The order of the Commission directing that the intercompany profit be excluded from the net book cost of the property on the appellee's books was proper.

We agree with the appellee that we are concerned here only with ascertaining the net book cost of the appellee's property, under the system of accounts which became effective on January 1, 1937. However, the net book cost must necessarily be determined historically by an examination of the transaction which gave rise to the figures now on the books. Obviously, if there was a write-up on the books of the company in the past, it must be eliminated and the accounts must be restated at true cost. The appellee would undoubtedly concede that, if the appellee had simply written up property which cost it eight million dollars to twelve million dollars, the four million dollar excess would have to be excluded in setting up the books of account on a cost basis and a corresponding charge would have to be made to surplus.

This is equally true if, instead of a simple write-up on the books of one company, the inflated book figure is the result of a transfer between two public utility companies, owned and controlled by the same interests, at a price in excess of the cost to the transferor. The excess over the transferor's cost reflected in the so-called purchase price, in such a case, does not represent actual cost; it does not represent any additional investment in the property.

The setting up of the inflated price on the books of the New York Telephone Company in this case, was improper, since it did not represent true cost or actual investment but was merely a write-up in connection with an intra-family transfer by a parent to a wholly owned subsidiary.

The principle here involved is not dependent upon the "original cost" provisions of the new Uniform System of Accounts which took effect on January 1, 1937. It is inherent in any system of accounting which is concerned with the recording of true investment or actual cost. The important point here is not merely that the inflated price does not represent the original cost to the transferor; the fact is that it does not represent an actual investment by any one.

Obviously, the question of value does not enter into a system of accounts kept on the basis of the cost. As this Court said in *Northwestern Electric Company* v. *Federal Power Commission*, 321 U. S. 119, at page 123:

> "A mere write-up belongs in none of these accounts and cannot properly appear in any other account on the asset side of the ledger. If it should so remain, it would have to be in a new account reflecting present value in excess of actual cost which would, in effect, be a plant appreciation account and the Commission's form of accounting does not permit the carrying of any such item in the asset account since its system is a cost system of accounting."

"Where property is transferred by a parent to a wholly owned subsidiary, there is no more right to enter the property upon the books of the subsidiary, under a cost system of accounting, at a price in excess of the parent's cost, than there is to write up the book cost of property which had been built by the subsidiary. In neither case, is the current value which may be established by appraisal or otherwise of any relevance.

The fact that the New York Telephone Company actually paid the price fixed by the A. T. & T. is in no way inconsistent with the finding that there was no additional investment or increase of actual cost by reason of the transaction. The A. T. & T. owned the surplus of the New York Telephone Company by virtue of its ownership of the common stock prior to the transaction and it continued to own the surplus thereafter. The payment was therefore virtually a payment by the A. T. & T. to itself. It was simply a transfer from one pocket of the A. T. & T. to another pocket. The true nature of the excess payment is made evident by the fact that, in any consolidated statement of the A. T. & T. and its subsidiaries, which may be issued at any time in the future, the increase in the surplus of the A. T. & T. created by the excess payment will have to be eliminated.

Likewise, the A. T. & T., through its ownership of the common stock of the New York Telephone Company, owned whatever equity the New York Telephone Company had in its property and it continued to own such equity after the making of the transfer. If the property transferred to the New York Telephone Company had any greater value at the time of the transfer than the cost to the A. T. & T., the A. T. & T. did not surrender that appreciation by transferring the property to the New York Telephone Company. The increased value would be reflected in the equity of the

New York Telephone Company in its property on a value basis and that equity would in turn belong to the A. T. & T. by virtue of its common stock ownership.

Looked at realistically, the transaction with which we are here concerned is not essentially different from a simple write-up on the books of the New York Telephone Company. If the A. T. & T. had transferred the property to the New York Telephone Company at its net book cost, instead of the inflated price, and then had directed the New York Telephone Company to write up the property to a higher book cost upon the basis of appraised value, and had caused the New York Telephone Company to transfer the "profit" thus created to the parent corporation by way of a dividend, the appellee would undoubtedly concede that the write-up would have to be eliminated from the New York Telephone Company's books. Yet the supposed transaction would not differ in substance from the transaction by which the appellee claims to have created an additional element of cost.

The order here under review requires the New York Telephone Company to disclose the true facts on its books of account and, by a direct charge of the excess payment to surplus, to show that such payment was in effect merely a transfer from its surplus to the surplus of its parent.

There is much said in the appellee's brief about the Interstate Commerce Commission system of accounts which was in force at the time of the transactions in question but, as we read that system, it, too, was a system based upon actual cost and the entry of an inflated figure upon the books of the appellee was inconsistent with the system. The specific provisions of the system upon which the appellee relies seem to us to relate only to an actual purchase, where an additional investment is made, and not to a transfer between a parent company and its subsidiary. In the case of an actual purchase, the system prescribes the method

of recording the purchase price. If the price actually paid is in excess of the so-called structural value, as defined in the I. C. C. system, so much of the price as represents structural value is to be entered in the plant accounts and the rest of the price is to be entered elsewhere. If, on the other hand, the price paid is less than the structural value of the property purchased, the price is to be distributed among the plant accounts in proportion to the structural value of the items of property included in the purchase. In no event is anything to be entered on the books in excess of the actual cost or the actual investment. Since there was no actual investment in this case in excess of the A. T. & T.'s net book cost, there was no justification, under the I. C. C. system, for the entry of any additional sum on the books of the New York Telephone Company.

The I. C. C. system does not purport to prescribe how the so-called price is to be arrived at, upon a transfer by a parent corporation to its subsidiary. It merely prescribes the accounting to be followed in recording whatever price may be fixed. The price is to be fixed by the parties, in accordance with the general principles of law governing public utility companies. It is settled, both under the federal authorities and under the law of New York, the state in which the transactions involved in this case took place, that, upon a transfer of public utility plant by a holding company to its wholly owned subsidiary, the price fixed may not exceed the net book cost of the transferor.

Colorado Interstate Gas Company v. *Federal Power Commission*, 324 U. S. 581;

Pennsylvania Power & Light Company v. *Federal Power Commission*, 139 Fed. (2d) 445; certiorari denied 321 U. S. 798;

New York Edison Company v. *Maltbie*, 244 A. D. 685 at p. 689; affirmed on other grounds 271 N. Y. 103;

Long Beach Gas Company, Inc. v. *Maltbie*, 264 A. D. 496, aff'd. 290 N. Y. 572;

Pavilion Natural Gas Company v. *Maltbie*, 268 A. D. 610;

Citizens Water Supply Co. of Newtown v. *Maltbie*, 267 A. D. 793; aff'd. 293 N. Y. 849.

These cases rest upon general principles of law wholly apart from any administrative accounting rule.

The New York Appellate Division pointed this out, in rejecting a proposed accounting rule, which would have required the writing-off of any payment in excess of original cost, even in an arms-length transaction:

> "The only persuasive argument advanced by counsel for the Commission as to the necessity for the rule was that property purchased by operating or subsidiary companies had been resold to the holding or parent company at an increased price, and this increased and inflated price placed in the fixed capital account of the holding or parent company. The Commission already had control of entries reflecting these wash sales, and the authority to require their elimination from a fixed capital account."
>
> *Matter of New York Edison Company* v. *Maltbie*, 244 A. D. 685, at p. 689.

In the absence of a rule of law such as that laid down by this Court in the *Colorado* case, *supra*, a parent corporation would be free to transfer property to its subsidiaries and to transfer property from one subsidiary to another at will, to reflect rises in the price level or changes in the judgment of appraisers from time to time and, in this way, to inflate the apparent cost of its property, with resulting deception or confusion of the regulatory agencies and the hampering or frustration of effective regulation.

When the I. C. C. system is read in the light of this background, it is apparent that the system was not intended to authorize a transaction of the type here under consideration.

It may be noted that this precise question arose in New York State in 1921, several years prior to the transactions in question, with respect to the interpretation of the New York system of accounts, which was then substantially the same as that of the I. C. C. General Instruction No. 7 of the New York system entitled "Plant and equipment and other property purchased" was substantially the same as §13 of the General Instructions of the I. C. C. system, upon which the appellee relies. On March 17, 1921, the New York Public Service Commission issued an order clarifying Instruction No. 7 by inserting the specific statement that "when there is substantial identity of interest between the vendor and the vendee the value assigned to tangible fixed capital accounts shall not exceed the original cost of such property to the vendor."*

---

* The instruction, as clarified in 1921, so far as here relevant, read as follows:

> ". . . When any telephone line or part thereof (excepting new or used material and supplies) is purchased for a lump sum, an appraisal of the property so acquired shall be made, classifying the various constituent elements in the property according to the accounts prescribed by this Commission in its Uniform System of Accounts for Telephone Corporations. The actual money value of the consideration given for the plant or other property purchased shall be distributed to such accounts in accordance with the appraisal, but in no case shall the values assigned to tangible fixed capital accounts exceed the cost to reconstruct such plant and equipment at prices in effect at the time of the purchase, *and when there is substantial identity of interest between the vendor and the vendee the values assigned to tangible fixed capital accounts shall not exceed the original cost of such property to the vendor. The estimated accrued depreciation on property purchased shall be set up on the books of the vendee as an offsetting liability to the cost of property so acquired.* . . ." (Italics supplied.)

The New York order was merely declaratory of the basic principle common to the New York system and the I. C. C. system. Both systems were based upon the principle of actual cost. Reasonably construed, in the light of this principle and of the general principles of law applicable to public utility transactions, neither system permitted an increased price upon a transfer from a parent to a subsidiary to be capitalized as an element of cost or as an additional investment.

However, we agree with the position taken by the Government in its brief in this Court that it is not necessary to rest the validity of the order of the Commission here under review upon the ground that the transactions were improper at the time that they took place. Even if it is assumed for the purpose of argument that the write-up was not forbidden by any judicial or administrative rule then prevailing, the fact remains that, as of January 1, 1937, the appellee was required to restate its accounts upon the basis of actual cost or actual investment and, upon that basis, any excess over its parent's net book cost, paid for property transferred to it by its parent, must be excluded from its books of account.

The power of the Commission to require the company to exclude from its net book cost a payment to its own parent in excess of the parent's net book cost rests upon the authority of the Commission to require the company to state its accounts anew on the basis of true cost or actual investment.

If the I. C. C. system is interpreted in accordance with the appellant's contention, then the I. C. C. system was not a cost system of accounting in its entirety but, so far as it applied to intercompany transactions within a single holding company system, it permitted "value" accounting. The permissibility of the original entries under such a sys-

tem is wholly irrelevant in determining what may properly be set up in books which are required to be stated on a cost basis.

In order to bridge the transition from the pre-existing accounts of the company to the accounts required to be set up under the uniform system as of January 1, 1937, the uniform system provides for the segregation and placing in Account 100.4—Telephone Plant Acquisition Adjustment of any sums in excess of the original cost of the property to the person first devoting it to the public service. As this account has been construed in actual application by the Federal Communications Commission and by the state commissions which have adopted similar provisions in their respective systems, this account is properly called into operation only in connection with an actual purchase from an outside interest, where the purchase price in part represents an additional investment above that originally made by the prior owners of the property. However, this account is sometimes used as a temporary resting place for an excess payment made to a parent corporation or to an affiliate within a single holding company system, prior to its being charged off to surplus. The use of the account in such a case is merely a matter of mechanics, because the charge to surplus follows immediately. A direct charge to surplus seems to us to be simpler and more easily understood; that is the course which the Commission adopted in this case.

It may be noted in this connection that the system of accounts adopted by the Federal Power Commission for electric corporations has an Account 107, entitled "Electric Plant Adjustments," in addition to an Account 100.5 "Electric Plant *Acquisition* Adjustments." The former account is used for the elimination of write-ups either of the simple one company type or of the two company type involved in

this case, where there is no true purchase and hence no "acquisition" adjustment to be made. Under the telephone system, Account 100.4 may be used to serve the function of Account 107 of the Federal Power Commission's system or a direct charge to surplus may be used instead.

When Account 100.4 is used to serve its primary function, in connection with true purchases from outside interests, the items segregated in Account 100.4 are not earmarked to be written off against surplus but are held for subsequent consideration, with a view to amortization or other disposition in accordance with the facts disclosed upon hearing or investigation. However, when the account is used in connection with a transaction of the kind here involved, there is no question of an additional purchase price actually paid to outside interests or of any additional investment in excess of the vendor's cost and hence there is no need for further consideration.

The appellee concedes that, at least as to the surviving property, the excess of the price charged the appellee by the A. T. & T. over the A. T. & T.'s net book cost should be placed in Account 100.4. However, the appellee advances no persuasive reason for allowing such excess to remain in Account 100.4 indefinitely or for refusing to charge it off at once against surplus. In view of the holding by this Court in *Colorado Interstate Gas Company v. Federal Power Commission*, 324 U. S. 581, such excess cannot be recognized as a true element of cost. It therefore has no place in books of account intended to reflect true cost or actual investment.

POINT II.

The inflation of the net book cost of the property on the books of the appellee was not eliminated by the subsequent retirement of part of the property.

In its brief in this Court, the appellee seeks to sustain the order of the court below upon a ground not mentioned in the opinion of the court, although it had been urged upon the court by the appellee.

The appellee contends that the inflation of the net book cost has been in part eliminated by the retirement of part of the property by charges to the Depreciation Reserve.

In examining this contention, it should be borne in mind that the net book cost consists of two factors: the book cost of the property entered on the asset side of the company's accounts and the related depreciation entered in the Depreciation Reserve on the liability side. It is the difference between these two figures which constitutes the net book cost. A write-up or inflation of net book cost may be brought about either by an inflation of the book cost figure on the asset side or by a reduction of the related depreciation figure on the liability side.

In this case, the inflation was accomplished principally by an understatement of the related depreciation. Taking the total figures, the entry on the asset side was \$12,634,-680.38. This figure happened to be somewhat less than the actual cost of the property new on the books of A. T. & T (\$13,269,567.47). However, on the books of the A. T. & T. there were related depreciation reserves (as determined by the A. T. & T. itself) of \$4,801,397.66, thus leaving a net book cost on the A. T. & T. books of \$8,468,169.81. Upon recording the transfer on its books, the appellee made no entry in the Depreciation Reserve

at all, thus making its net book cost \$12,634,680.38, or an inflation in net book cost over the net book cost of the A. T. & T. of \$4,166,510.57. This is the "profit" on the transaction which went into the Surplus of the A. T. & T.

The omission of the related depreciation reserves thus created an inflation of the net book cost of the property of about \$4,000,000.

In view of the manner in which the inflation of net book cost was brought about, it is obvious that the subsequent retirement of the property could not cure the distortion of the accounts. Assuming that the annual depreciation charges relating to this property were subsequently accrued at the standard rates of depreciation used by the appellee, there could not be a sufficient sum in the depreciation reserves to absorb the whole book cost of the property upon its retirement. There would be in the reserves only so much as was subsequently accrued by the annual charges; the initial omission of the depreciation accrued to the time of the transfer would remain unaffected and the depreciation reserve would still be understated by that amount. Since the depreciation reserve would be debited with the whole book cost of the property upon its retirement, the depreciation reserve would be depleted to the extent to which the book cost exceeded the amount of the related depreciation accrued in the reserve. After the retirement of the property, it is true that the property would no longer be reflected on the asset side of the accounts but the original distortion of net book cost would remain. The original deficiency in the related reserve would simply be transformed into a depletion of depreciation reserves which had been accumulated by the company for the purpose of covering the retirement of other property.

The order under review here eliminates this distortion of the accounts by directing a transfer of about $4,000,000 to the depreciation reserve and a corresponding debit to surplus.

Upon analysis, it will be seen that the order does not purport to review the adequacy of the depreciation reserve as a whole nor does it deal with the depreciation practices of the appellee. The fact that the appellee uses a group method of computing depreciation has no relevance here. The order deals solely with the elimination of a write-up of net book cost. Since the write-up consisted of an omission of a credit to depreciation reserve, it must necessarily be corrected by a direction to transfer the appropriate amount from surplus to the depreciation reserve.

The appellee's principal argument in this connection seems to relate to the procedure by which its accounts are to be corrected rather than to the merits of the Commission's order. The appellee argues that, after the retirement of the property, the distortion of the appellee's accounts which resulted from the transaction may no longer be corrected by a specific order of the Commission directed to that end, but may be corrected only in connection with a general investigation of the depreciation reserves of the appellee. No plausible reason is advanced for thus restricting the Commission's power and preventing it from dealing with each specific transaction as the facts with respect thereto come to light. Clearly, the Commission has the right to root out an improper entry and to follow it through to all of its consequences in the accounts of the company. Since the distortion is reflected in the depreciation reserve, the Commission has the right to direct the

appropriate correction of that account without undertaking a general investigation of the adequacy of the account as a whole.

If the appellee's view were accepted, no correction could be ordered by the Commission unless the Commission was prepared to establish that the account to which the correction relates is in all other respects correct and that there is no offsetting element in the account which might tend to neutralize or mitigate the effect of the particular distortion.

The argument which the appellee makes on this point could be advanced with equal relevance in connection with a simple one company write-up of an item in the asset accounts; its unsoundness in such a case makes evident its unsoundness in this case. For example, if the book cost of an item of property had been written up on the asset side, the appellee would argue that the Commission was powerless to correct the write-up until it had examined all the other items in the plant account to determine whether perchance there was some understatement in some other unrelated transaction which might offset the write-up. Such a contention would clearly be untenable.

It is suggested by the appellee that the annual accruals to depreciation reserve which it made during the period from 1925-1928 to January 1, 1937, not only took care of the currently accruing depreciation but also made up for the omission of $4,000,000 of accrued depreciation in the initial entries in connection with the property here in question. This is a startling argument for a regulated public utility to offer as a ground for refusing to correct a write-up. In effect, the argument amounts to this: that during the period in question, the appellee charged as part of its operating

expenses an excessive amount for the depreciation accruing during the period and that this excess was large enough to offset the write-up so that its net book cost on January 1, 1937, is the same as if there had been neither a write-up nor excessive depreciation accruals thereafter. On its face, the excuse would seem to be worse than the act sought to be excused. If any such practice were followed, it was certainly unfair to the consuming public whose rates were based upon the operating expenses, including the annual depreciation charges, and it was certainly misleading to the regulatory agencies.

In any event, the record clearly sustains the conclusion of the Commission that no subsequent depreciation accruals were made for the purpose of offsetting the write-up. It should be borne in mind that the total book cost on the asset side, which is the base to which the rates of depreciation are applied in computing annual depreciation, was not in excess of, but in fact was somewhat less than, the actual cost of the property new. Therefore, no amortization of the write-up resulted from the application of the standard rates of depreciation. There is no evidence that any additional or special charges for depreciation were made directed toward the correction of the distortion of the accounts growing out of the transactions here in question.

In view of the fact that the proof clearly showed that there had been a distortion of the net book cost by the transactions of 1925-1928, the burden of proof rested heavily upon the appellee to establish by clear and convincing evidence that the distortion had been removed or neutralized by subsequent charges or accruals and, if it was claimed by the appellee that the distortion had been partly corrected, the burden rested upon it to establish the exact extent of such correction. This burden of proof was not sustained by the appellee.

There was substantial evidence in the record to support the Commission's conclusion that the distortion had not been corrected to any extent; the conclusion of the Commission on this point must therefore be sustained.

Conclusion.

The judgment appealed from should be reversed.

Respectfully submitted,

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Dated: November 12, 1945.

SUPREME COURT OF THE UNITED STATES.

No. 55.—October Term, 1945.

The United States of America and Federal Communications Commission, Appellants, *vs.* New York Telephone Company.	Appeal from the District Court of the United States for the Southern District of New York.

[January 28, 1946.]

Mr. Justice Rutledge delivered the opinion of the Court.

This case presents new questions of "original cost" accounting, which arise from an order of the Federal Communications Commission requiring readjustments in appellee's accounts. A detailed statement of the facts is necessary to an understanding of the issues. But the short effect of the controversy is that the Commission has required the appellee, New York Telephone Company, to make charges of some $4,166,000 to surplus, with corresponding credits to other accounts; the ultimate effect being substantially to compel the elimination of so-called write-ups from the company's accounts in order to bring them, to this extent, into conformity with the Commission's Uniform System of Accounts, which is based upon "original cost." The attacked entries were made in 1925, 1926, 1927 and 1928, prior to enactment of the Federal Communications Act, upon acquisition by appellee of business and property from its affiliate, American Telephone and Telegraph Company. The case embodies a rather long delayed chapter of the broad controversy presented in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232, to be discussed later.

For preliminary purposes it is enough to say that the appellee questions the Commission's power to make the order in issue and a District Court, composed of three judges, has permanently enjoined its execution. 56 F. Supp. 932. From that judgment this appeal has followed.

We turn to the facts before undertaking to state the issues more precisely. Appellee, the New York Telephone Company, is a subsidiary of the American Telephone and Telegraph Company, which owns all its common stock. Since its incorporation in 1896 appellee has engaged in the business of furnishing intra-

state and interstate telephone service to the public in the states of New York and Connecticut. Prior to 1925, for historical reasons, American also had furnished intrastate toll service between certain points in New York State; but in that year, as part of its plan to withdraw from all such business, American transferred its intrastate toll business in New York State to the appellee.

In connection with this transaction occurred the four transfers of property, the accounting for which now concerns us. In November, 1925, September, 1926, and December, 1928, appellee purchased from American certain toll plant consisting of property such as poles, crossarms, guys and anchors, aerial wire and cable, underground cable, loading coils, conduit, and right of way. This property was needed to handle the additional intrastate business which had been transferred to it. Much of the property so acquired was in the form of an additional interest in toll plant which, prior to these transfers, had been jointly owned by American and New York.

The fourth sale took place in 1927. Before that time American had retained ownership of three essential parts, collectively called "the instruments"—the transmitter, receiver and induction coil—of the telephone stations used by subscribers. American had furnished and maintained these instruments under a contract between it and New York under which New York paid it a specified percentage of its gross revenues. In December, 1927, American sold to New York the instruments then in the service or supplies of New York.

None of these transfers of property changed the physical character of the plant or the service rendered to the public. The sole effects were to shift certain operating costs of American and certain fixed charges and taxes connected with the ownership of the property to New York and to eliminate New York's obligation to make payments to American for use of "the instruments"; for the rest, as the New York Public Service Commission described the transfer, it was "a bookkeeping transaction, with no change in ultimate ownership, in location, or in use of the . . . property, but reflecting only a revised business relationship between affiliated corporations."[1]

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[1] Opinion of the New York Public Service Commission, Case 9436, adopted December 14, 1943, 1 Report of the Public Service Commission (1943) 569, 571.

American and New York agreed that the purchase price of the toll plant was to be an amount equal to its "structural value." As defined by the Uniform System of Accounts for Telephone Companies (Instruction 13) of the Interstate Commerce Commission, this was "the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy." A field inspection and an appraisal of the property were made by engineers, and appellee paid to American a total of $5,973,441.47 for the toll plant. The purchase price of the instruments transferred in 1927 was $6,661,238.91. This was based on the average price charged American by the Western Electric Company, the manufacturer and also a subsidiary of American, during the first nine months of 1927, less a twenty per cent allowance to reflect the then existing condition of the instruments.

The tables set out in the margin show the accounting treatment of these transfers at the time they occurred.[2] As the tables disclose, the "profit" to American, that is, the difference between the net book cost to it and the record book cost to New York, was $4,166,510.57. This amount American credited to surplus accounts as profit on the transactions.

This "profit," of course, arises from the fact that New York in making its accounting entries ignored the original cost to American and the depreciation which had accrued on the books of American up to the time of transfer, and entered solely the actual price paid by it for the properties. It did not, so to speak, "fold in" the net book cost to American.

Having set down these properties on its books at the price it paid to the parent corporation for them, New York then applied what it calls the "group method" of depreciation.[3] Under

Property Group	Book Cost to American	Related depreciation and amortization reserves	Net book cost of American	Recorded book cost to New York	Excess or "Profit" to American
—Toll line Property	$5,010,840.19	$801,858.95	$4,208,481.24	$5,831,884.78	$1,623,403.54
—Toll line Property	95,924.66	14,449.20	81,475.46	97,310.39	15,834.93
—Toll line Property	28,077.64	4,144.78	23,932.86	44,246.30	20,313.44
—Telephone instruments	8,135,224.98	3,986,944.73	4,154,280.25	6,661,238.91	2,506,958.66
Total	13,269,567.47	4,801,597.66	8,468,169.81	12,634,680.38	4,166,510.57

[3] The Federal Communications Commission defines " 'Group plan', as applied to depreciation accounting" as "the plan under which the depreciation charges are accrued upon the basis of original cost . . . of all property included in each depreciable plant account, using average service life thereof properly weighted, and upon the retirement of any depreciable property its

this method special depreciation rates were not applied to the property in question, despite the fact that it had a relatively short remaining life. Instead the current depreciation rates applicable to similar classes of plant were applied as long as the property remained in service. As portions of the property were retired, they were written out of the plant account at the amounts at which they had been recorded therein, that is, at the structural value; and debits of corresponding amounts, less allowance for salvage, were charged concurrently to the depreciation or amortization reserve.

On January 1, 1937, the Uniform System of Accounts of the Federal Communications Commission[4] for Class A and Class B telephone companies became effective[5] and applicable to New

full service value is charged to the depreciation reserve whether or not the particular item has attained the average service life." 47 Code Fed. Reg. 31.01-3(p).

[4] The Communications Act of 1934 (48 Stat. 1064) provides:

"Sec. 220 (a). The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys."

"Sec. 220 (c). The Commission shall at all times have access to and the right of inspection and examination of all accounts, records, and memoranda including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by such carriers, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto. The burden or proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by such person. . . ."

"Sec. 220 (g). After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect."

Prior to passage of the Communications Act the power to prescribe accounts for telephone companies had been lodged with the Interstate Commerce Commission. Interstate Commerce Act § 20(5), 41 Stat. 493, subsequently amended, 54 Stat. 917. See American Telephone & Telegraph Co. *v.* United States, 299 U. S. 232, 235-236.

[5] The order of the Federal Communications Commission prescribing a uniform system of accounts for telephone companies having average annual operating revenues exceeding $50,000, was adopted on June 19, 1935, 1 F. C. C. 45, and was originally to be effective January 1, 1936. This order was stayed because of the proceeding in the American Telephone & Telegraph Co. case, *supra* note 4, and did not become effective, as amended, until January 1, 1937. 3 F. C. C. 9.

York. Under this system telephone companies were obliged to establish or reclassify their investment accounts on the basis of "original cost."[6]

In reclassifying its accounts as of January 1, 1937, New York estimated the amounts attributable to the surviving toll plant received from American, which it originally had included in its books on the basis of structural value. New York then determined the difference between those estimates and what it estimated was the original cost of such surviving plant to American. The difference was placed in Account 100.4, Telephone Plant Acquisition Adjustment. Account 100.4 includes amounts "representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the properties acquired."[7]

In 1938 New York began amortizing this sum by charges and credits to its operating expense Account 614, Amortization of Telephone Plant Acquisition Adjustment, with concurrent entries to Account 172, Amortization Reserve. As portions of the acquired plant were retired, amounts in Account 100.4 were written out of that account and concurrent entries were made in Account 172.

On June 16, 1942, the Federal Communications Commission instituted the present proceeding by ordering a general investigation into the accounting performed by appellee at the time of and subsequent to the four transfers of property involved in this suit. The order required New York to show cause why $4,166,-510.57 (the difference between book cost to American, less related

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[6] The Rules and Regulations of the Federal Communications Commission provide that "'Original cost' or 'Cost,' as applied to telephone plant, franchise, patent rights, and right-of-way, means the actual money cost of (or the current money value of any consideration other than money exchanged for) property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors." 47 Code Fed. Reg. 31.01-3(x).

[7] At the same time appellee transferred from its Account 171, Depreciation Reserve, to its Account 172, Amortization Reserve, an amount which, when supplemented by future accruals over the estimated remaining life of the plant at the then current depreciation rates, would provide a reserve equivalent to the amount in question in Account 100.4 at the termination of the life of the property involved.

depreciation, and the structural value of the property as recorded on the books of New York) should not be charged to its Account 413, Miscellaneous Debits to Surplus, with concurrent entries to such accounts as might be appropriate. The order also suspended all charges to operating expense accounts made by New York on or after January 1, 1943, for the purpose of or in conjunction with amortizing or otherwise disposing of amounts included in Account 100.4, pending submission of proof by respondent of the propriety and reasonableness of such charges.[8]

A joint hearing was then held with the New York Public Service Commission, and in June, 1943, the Federal Communications Commission issued its proposed report. After oral argument before the Commission sitting en banc, a final report and order were issued on December 14, 1943. 52 P. U. R. (N. S.) 101. The order directed New York to charge $4,166,510.57 to its Account 413, Miscellaneous Debits to Surplus, and to make appropriate concurrent entries to other accounts.[9]

New York then brought this suit before a district court of three judges to enjoin the Commission's order.[10] Appellant's motion for summary judgment was denied and on January 2, 1945, as has been said, the District Court entered its judgment permanently enjoining the order. 56 F. Supp. 932. The court held that the accounting entries were legal when made, since they were in accordance with the accounting system then prescribed by the Interstate Commerce Commission; and that, consequently, the Commission could "not apply retroactively a new system to write down the plaintiff's surplus." The court also held that the Commission's order was contrary to this Court's decision in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232, and to a "stipulation" filed in that cause by the Solicitor General. The present appeal followed.

[8] The Commission's order was grounded upon the provisions of § 220(e) of the Communications Act. See note 4.

[9] On the same date the New York Public Service Commission also adopted its final report and reached the same conclusion. See note 1. We are informed by a brief amicus curiae filed by the New York Public Service Commission that "a proceeding for the review of the order of the New York Commission has been brought in the Appellate Division of the Supreme Court of the State of New York but the argument thereof has been deferred pending the decision by this Court in the present case."

[10] Section 402(a) of the Communications Act makes applicable to orders of the Federal Communications Commission, with certain exceptions, the Urgent Deficiencies Act. 38 Stat. 219, 220.

Appellee's first argument in support of the District Court's decision is a simple one. It is, shortly, that the Commission's order was premised upon the conclusion that the original accounting entries were illegal when made. Appellee disputes this, maintaining that the accounting entries made prior to January 1, 1937, were in full accordance with the system of accounts prescribed by the Interstate Commerce Commission. That system, by the argument, was based not upon original cost but upon actual cost "without distinction between acquisitions from affiliated companies and acquisitions from other than affiliates."[11]

The answer to this contention is equally simple. It is not necessary to decide whether the accounting entries, when made, were legal under the system promulgated by the Interstate Commerce Commission; for we think the order in review was not based exclusively upon that premise. It is true that language in the Commission's report, when read out of context, might be taken to lend support to appellee's position. But the report, read as a whole, shows that the Commission's order for the readjustment of the accounts went on the view that the inflation was not justifiable in the light of its own original cost system of accounts. The Commission may have thought, as an alternative ground for its decision, that the accounts were illegal when made;[12] but the principal foundation of the order was that appellee was legally subject to the requirement of restating its accounts on the basis of original cost;[13] and consequently any excess on its books over American's net book cost must be eliminated.

We turn therefore to New York's further argument, which

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[11] The District Court apparently accepted this argument, for it said: "The order under review proceeds upon the theory that plaintiff's account in question was improper when made and should be corrected." 56 F. Supp. at 938.

[12] Cf. Opinion of the Public Service Commission of New York holding, in part, that the Interstate Commerce Commission accounting requirements did not oblige New York "to write up the book value of system property or to inflate surplus by intra-system profits. But the adroit companies found it a convenient excuse for inflating book values." 1 Report of the Public Service Commission (1943) 569, 587.

[13] See American Telephone & Telegraph Co. v. United States, 299 U. S. 232, 242: "We are not impressed by the argument that the classification is to be viewed as arbitrary because the fate of any item, its ultimate disposition, remains in some degree uncertain until the Commission has given particular directions with reference thereto. By being included in the adjustment account, it is classified as provisionally a true investment, subject to be taken out of that account and given a different character if investigation by the Commission shows it to be deserving of that treatment."

begins with a concession. The brief admits that the Commission "could require *the balances remaining* in appellee's property accounts to be reclassified." (Emphasis added.) But it is urged that the Commission properly can go no further. Since portions of the property have been retired and written out of the plant account at the amount at which they were recorded originally and since corresponding charges have been made concurrently to the depreciation reserve,[14] appellee says the Commission is without power, perhaps under the terms of the Communications Act, but at any rate under its own system of accounts, to order a reclassification of the entries for plant which has now been retired.

The Government answers that the effect of the write-up caused originally by New York's recording the property at structural value rather than at American's net book cost has never been eradicated. It points to the fact that New York did not apply a special depreciation rate to the property in question although it was not new and its price purported to reflect existing depreciation. Thus, the Government in effect asserts that there has been an under-depreciation.[15] New York denies this. It says that the group method,[16] under which the property was depreciated at rates similar to those applying to like property, takes into account the fact that some property may remain in service for a shorter time than is expected and that some property may remain serviceable for a long time. Under the group method, it insists, such inequalities are averaged out in the rate fixed for the group as a whole.

The effect of appellee's argument would be to render the Commission powerless to write off much of the inflation caused by the original accounting in this case. For, as has been pointed out, the inflation is not "removed as property is retired. . . . When property is retired its cost is credited to the proper asset account and (neglecting the effect of salvage) the same cost is debited

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[14] See text at note 3.

[15] The brief amicus curiae of the New York Public Service Commission states: "A write-up or inflation of the net book cost may be brought about either by an inflation of the book cost figure on the asset side or by a reduction of the related depreciation figure on the liability side.

"In this case, the inflation was accomplished principally by an understatement of the related depreciation."

[16] See text at note 3.

to depreciation reserve, and the resultant change in book value is zero. Thus the effect of retiring an inflationary asset item is to create a deficiency in depreciation reserve equal to the inflation formerly existing in the asset account."[17]

Moreover, it would seem clear that rates established under the group method of depreciation are not properly applied to property purchased which is *known* not to have as long an expected serviceable life as property of the same sort purchased when new. It is true that testimony appears in the record that at the time of the purchase of the property "the question of the effect of this purchase on the depreciation rates, and whether or not the depreciation rates should be increased so [as] to allow for the fact that the property purchased was not new and, therefore, had less than the full life remaining" arose and was considered. True also, testimony showed it was decided at the time "that without any increase in the rates the rates that were already in effect would be ample to provide for retirement of the property purchased." Nevertheless the Commission apparently found that such was not the case.

We cannot say that such a conclusion was erroneous.[18] And it may be added, in support of the Commission's desire to put New York's accounts on an original cost basis, that one of the effects of original cost accounting will be not to require New York in the future to do what it should have done in the past, at least under the Federal Communications Commission system of ac-

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17 Opinion of the New York Public Service Commission, 1 Report of the Public Service Commission (1943) 569, 590.

18 The Commission stated: "New York attempted to counter these conclusions with the contention that its depreciation reserve *as a whole* is now in excess of requirements and consequently the inflation introduced through the accounting for the transactions in question has been offset by an excess in the reserve resulting from other causes; and that, further, unless the Commission can show that the reserve as a whole is deficient no correcting entry which would increase the reserve can be required. But the question as to whether the depreciation reserve, taken as a whole, is adequate is irrelevant to the issues herein. No challenge is here being made to the adequacy of the depreciation reserve as a whole. This line of argument represents an attempt to offset one error by another. If New York's depreciation reserve is in excess of requirements, it means that New York has been making excessive charges to operating expenses for depreciation." 52 P. U. R. (N. S.) 101, 116-117.

It has been urged that, even if the Federal Communications Commission was correct in ordering the inflation in the accounts of New York written off the books, that inflation has been reduced by some fraction of the depreciation previously taken, that is, prior to elimination of the inflation, even though the group method of depreciation was employed. That point, whatever its merits, was not made until the case reached this Court. Accordingly we do not consider it.

counts. " . . . The depreciation rate [under original cost accounting] applicable to a specific class of plant can be based on an estimate of total service life. There is no necessity to depreciate part of the account (constructed plant) on a total service life basis and another part (acquired properties) on a remainder life basis."[19]

Appellee further urges that so much of the Commission's order as affects property already retired is improper, because the sole purpose of original cost accounting is to show separately the amount by which the price paid by the accounting company for property now in service exceeded the original cost of that property. But the purposes of an original cost system of accounting are broader. Under such a system the inflation in accounts not only may be segregated but may also be written off.[20] *Northwestern Elec. Co.* v. *Federal Power Commission*, 321 U. S. 119, 123-124; *California Oregon Co.* v. *Federal Power Commission*, 150 F. 2d 25, 27-28.

The final question is whether the order falls within the decision in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232. That case involved an attempt to set aside an order of the Federal Communications Commission prescribing a uniform system of accounts for telephone companies. The companies objected to the order's "original cost" provisions as preventing them "'from recording their actual investment in their accounts' with the result that the accounts might not fairly exhibit their financial situation to shareholders, investors, tax collectors and others." The Court replied that such a consequence would not be entailed, but that under the order only such an amount would be written off "as appears . . . to be a fictitious or paper increment." 299 U. S. at 240. However, to avoid possible misunderstanding and to give assurance to the companies, the Court requested the assistant attorney general appearing for the Government to reduce to writing his statement in that regard in behalf of the Commission. This he did, informing the Court that

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[19] Colbert, Advantages of Original Cost Classification of Plant (1945) 35 Public Utilities Fortnightly 333, 343.

[20] For obvious reasons, the utility companies have not objected so much to the segregating of the difference between the cost to the accounting company of property acquired and original cost less depreciation as they have to removing this difference from the books. See Kripke, A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107 (1944) 57 Harv. L. Rev. 433, 438 ff., especially at 445.

"the Federal Communications Commission construes the provisions of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4" as meaning "that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization." This statement the Court accepted "as an administrative construction binding upon the Commission in its future dealings with the companies." The Court also noted that the case was to be distinguished from *New York Edison Co. v. Maltbie*, 244 App. Div. 685, aff'd, 271 N. Y. 103, "where under rules prescribed by the Public Service Commission of New York, there was an inflexible requirement that an account similar in some aspects to 100.4 be written off in its entirety out of surplus, whether the value there recorded was genuine or false."

The District Court thought the order in the instant case was erroneous "in view of the stipulation of these same defendants made in American T. & T. Co. v. United States, supra; certainly in the absence of proof that the excess of price over the seller's net book cost was not a 'true increment of value.' There has not been any determination based upon a fair consideration of all the circumstances in accordance with the stipulation mentioned, nor upon the evidentiary circumstances referred to in the opinion of the Supreme Court." 56 F. Supp. at 938.

We think this misconceives the "stipulation's" purport and effect. When the Federal Communications Commission finds, after full hearing and on evidence which sustains the finding, that part of the cost on the books of a company is due to a profit made by an affiliate or a parent at the time when the affiliate or parent has transferred property to it, the Commission has determined, "after a fair consideration of all the circumstances" in full compliance with the "stipulation's" reservation that there has been no true investment but only a "fictitious or paper increment" within the meaning of the *American Telephone and Telegraph Company* case.[21] The stipulation did not foreclose, rather it in

[21] All relevant facts pertaining to the transaction were before the Commission. The Commission found that there was no real increment of value to the assets as a result of the transfer and that the inclusion of any write-up

terms reserved this inquiry. "For an intercorporate profit which upon a consolidated income statement of the affiliated group would disappear entirely is too lacking in substance to be treated as an actual cost." *Pennsylvania Power & Light Co.* v. *Federal Power Commission*, 139 F. 2d 445, 450. Indeed the opinion in the *American Telephone and Telegraph Company* case said: "There is widespread belief that transfers between affiliates or subsidiaries complicate the task of rate-making for regulatory commissions and impede the search for truth. Buyer and seller in such circumstances may not be dealing at arm's length, and the price agreed upon between them may be a poor criterion of value." 299 U. S. at 239.

It is argued, however, that the use of the word "may" was intended to put the burden on the Commission to find that in such inter-affiliate or parent-subsidiary transactions the price actually was a poor criterion of value. That is not our understanding. In the first place, the Act imposes upon the company, not on the Commission, the burden of proof to justify accounting entries. Neither the Court nor the Commission, in action taken with relation to the "stipulation," can be thought to have undertaken to shift this burden in the teeth of the statutory provision, as the full terms of the "stipulation," set forth below,[22] disclose.

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would introduce "inflationary elements" into the plant accounts which in time would be "improperly reflected in the depreciation expense account as an alleged operating cost." No other findings were necessary. And the rejection by the Commission of the company's contention that reproduction cost less depreciation was the true criterion of "value" was plainly no error of law.

[22] The entire statement (sometimes called "stipulation") of the Government in the *American Telegraph & Telephone Company* case (exhibit 3 in the instant case) reads as follows:

"The Federal Communications Commission construes the provision of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4, as follows:

"(1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4 provision will be made for their amortization.

"(2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provisions will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 186) or account 675 (R. 205).

"The Commission believes that the foregoing construction of its order is that which it presented to the District Court through the affidavits of its witnesses:"

We think that the use of the conditional was meant to indicate no more than that this Court was not taking sides in the debate in accounting circles as to whether the price agreed upon between affiliates was or was not in fact a poor criterion of value. To resolve that discussion was and is for the regulatory commissions and not for the courts. We repeat that for a court to upset an accounting order it must be " 'so entirely at odds with fundamental principles of correct accounting' . . . as to be the expression of a whim rather than an exercise of judgment." 299 U. S. at 236-237. The order in this case is not of that character.[23]

The judgment is

Reversed.

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[23] The Federal Power Commission, the Securities and Exchange Commission, and some state commissions (see the opinion of the New York Public Service Commission in the instant case) have taken the same position concerning interaffiliate transactions as has the Federal Communications Commission. See Kripke, A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107 (1944) 57 Harv. L. Rev. 693, 705-708.

Mr. Chief Justice STONE is of opinion that the judgment should be affirmed on the ground, as the court below held, that petitioner, the Federal Communications Commission, is bound by and has not complied with the stipulation to which it was a party and which this Court approved in *American Tel. & Tel. Co. v. United States*, 299 U. S. 232, 240, 241. In that case it was contended that the Federal Communication Commission's uniform system of accounts for telephone companies would require that all amounts representing excess of purchase price paid by the telephone company to its parent company over the seller's original cost be written off.

The Court held that under that system, applied to the account here in question, which had been lawfully established under Interstate Commerce Commission regulations, only such amount could be written off as appeared "to be a fictitious or paper increment", and not "a true increment of value." To avoid "the chance of misunderstanding and to give adequate assurance to the companies [including respondent here] as to the practice to be followed," the Court requested the Assistant Attorney General to reduce his statements to that effect to writing in behalf of the Commission. He did this and informed the Court "that 'the Federal Communications Commission construes the provisions of Tele-

phone Division Order No. 7-C, issued January 19, 1935, pertaining to account 100.4' as meaning 'that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.' ".

Before the Commission could rightly direct that the assets in that account, which have not been retired, be written off, the stipulation required it to find, after a "fair consideration of all the circumstances" that the difference between the original cost and the price claimed to have been paid is not "a true increment of value". This the Commission has not done. In the face of its stipulation it may not assume, without a finding based upon evidence, that there is no "true increment of value" to the assets which respondent purchased over the cost to the seller, merely because respondent purchased the assets from its parent corporation.

The judgment should be affirmed.

Mr. Justice Black, Mr. Justice Reed and Mr. Justice Jackson took no part in the consideration or decision of this case.